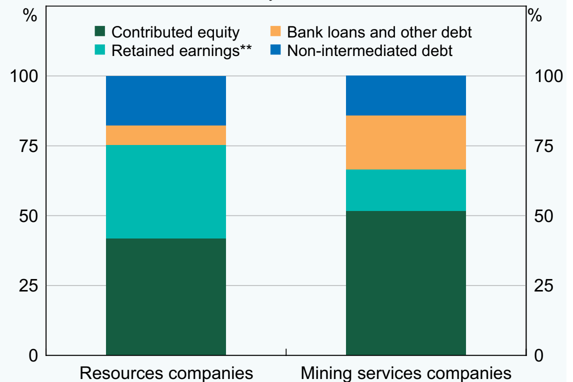
Box B

The Financial Condition of Companies Servicing the Mining Sector

Falls in commodity prices during 2012 led to a reassessment of the conditions and outlook for the mining sector. As a result, mining companies have scaled back their investment plans, with the peak in mining investment as a share of GDP now expected to be lower and to occur earlier than had previously been forecast.

While this highlights a degree of downside risk to mining revenue, which could have important flow-on implications for macroeconomic activity, the direct implications of the revised mining sector outlook for the financial system are likely to be limited; mining companies are typically not highly geared and make little use of intermediated debt (Graph B1).[1] However, there could in principle be indirect implications via companies that service the mining industry, given that these companies have tended to rely more on intermediated debt to fund their investment and are somewhat more highly geared, on average, than mining companies. A significant reduction in demand for mining-related services may therefore mean that some mining services companies could face greater difficulties in repaying their debt; this could lead to loan losses for financial intermediaries even though their overall exposure to mining services companies is small. This box reviews the financial condition of mining services companies in Australia, including their links to the banking sector. Overall, the mining services sector looks reasonably well placed to weather weaker demand for a period and it is therefore unlikely to pose a significant financial stability risk.



* Listed companies; excludes foreign-domiciled companies; book value of outstanding stock
** Includes reserves
Sources: Morningstar; RBA; company reports

Mining services companies are defined broadly in this box as those providing products or services to the mining sector. These include construction and contract mining, and other mining services, such as equipment, transport, and consulting and scientific services.[2]

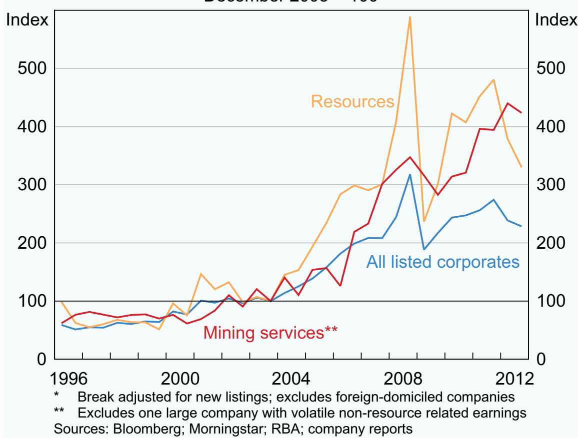
Consistent with the expansion in mining activity and investment, the mining services sector has grown strongly over the past decade. To meet the demand from mining companies, the mining services sector has accumulated assets at a considerable pace, particularly in the form of plant and equipment recently. In line with this, data from company financial reports indicate that earnings growth in

1 For a more detailed discussion on the funding of investment by the resources sector, see Arsov I, B Shanahan and T Williams (2013), 'Funding the Australian Resources Investment Boom', RBA *Bulletin*, March, pp 51–61.

2 The data cover 64 listed companies that have been identified as meeting this definition and are in the industrials, materials and energy sectors of the Global Industry Classification Standard. These companies account for around 6 per cent of the total market capitalisation of listed non-financial corporations. The data include some large and quite diversified companies, although exposure to the mining sector for these companies is still sizeable – at least around 20 per cent of their revenue.

the listed mining services industry kept pace with the strong earnings growth of the listed mining industry between the December half 2003 and the December half 2011, at an average annual growth rate of around 20 per cent (compared with 13 per cent for the broader listed sector) (Graph B2). More recently though, earnings of the listed mining sector have declined sharply, and the scaling back of planned investment expenditure and cost cutting by the sector has reduced actual and expected earnings of listed mining services companies. One implication is that some of the newly acquired capital assets of mining services companies might not be fully utilised, which could affect the sector's profits and its ability to repay debt.

Graph B2
Listed Corporates' Earnings*
December 2003 = 100

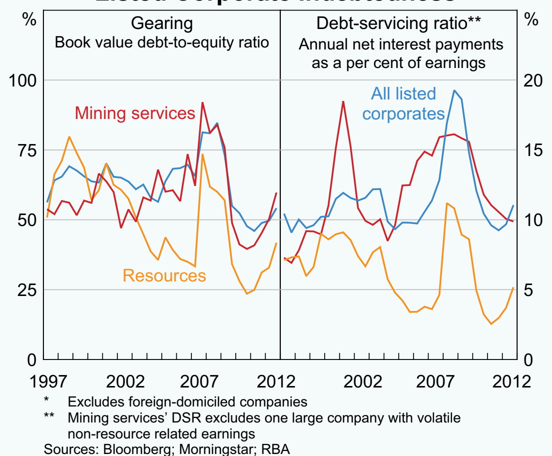


* Break adjusted for new listings; excludes foreign-domiciled companies
** Excludes one large company with volatile non-resource related earnings
Sources: Bloomberg; Morningstar; RBA; company reports

Because the earnings of the defined group of mining services companies are not solely determined by mining-related activities, the effect of any downturn in mining investment should be partially mitigated by demand from other sectors. Indeed, for the larger mining services firms, almost half of their revenue is estimated to be sourced from non-mining activities. The limited available data for smaller mining services companies suggest that several have diversified revenue streams, though they tend to be more reliant on mining-related activities than larger firms. Even within the mining-related component, revenue is derived from a range of activities. As more investment projects are completed in the years ahead and additional mining production comes on stream, some mining services firms will see rising production-related revenue offset declining construction-related revenue.

The financial resilience of the mining services sector, as well as the linkages to the financial system, is influenced by the composition of these companies' funding. In the early to mid 2000s, mining services companies tended to rely on a fairly stable mix of debt and equity to fund their growth. But their funding became increasingly concentrated in debt in the lead-up to the crisis, resulting in an increase in aggregate gearing (Graph B3). After a period of deleveraging in the aftermath of the crisis, which was also evident in the broader listed non-financial sector, the mining services sector has begun to rely on debt funding again in the past few years. That said, at around 60 per cent, the aggregate gearing ratio of mining services firms is still only around its historical average. It is notably higher than the aggregate gearing ratio among mining companies, but only slightly higher than for the broader listed

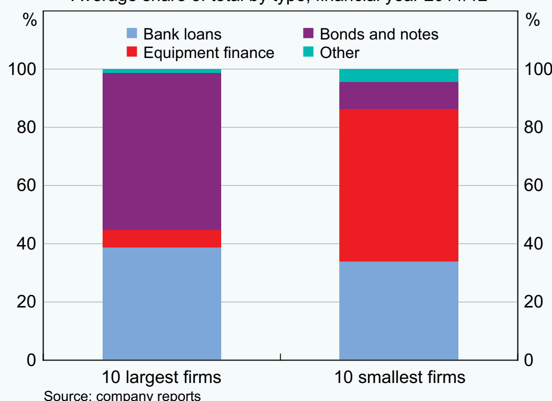
Graph B3
Listed Corporate Indebtedness*



* Excludes foreign-domiciled companies
** Mining services' DSR excludes one large company with volatile non-resource related earnings
Sources: Bloomberg; Morningstar; RBA

non-financial sector. Despite increased debt, because of low interest rates and strong earnings the proportion of earnings used to service debt is currently quite low, at around 10 per cent.

Within debt funding, the portion that is intermediated is the principal channel through which weakness in the mining services sector could have an effect on the banking sector. Even for the 10 largest mining services companies that have access to bond markets, bank loans account for about 40 per cent of their total debt, on average, and equipment finance arrangements (sourced largely through banks) account for a further 6 per cent. Much of this borrowing is in the form of syndicated loans, however, meaning that the credit risk is spread across a number of financial institutions. By contrast, smaller mining services companies generally do not have access to bond markets. They are therefore more reliant on intermediated credit; bank loans and equipment finance arrangements account for most of their debt (Graph B4).



Overall, despite the recent increase in debt, its low gearing and debt-servicing ratios suggest that the mining services sector is fairly well placed to cope with a period of weaker demand. Additionally, diversification in sources of revenue should shield the sector somewhat from any deterioration in mining-related investment demand. Given this, and combined with the small overall exposure of financial intermediaries to both the mining and mining services sectors, a slowing in mining investment is unlikely to have substantial near-term implications from a financial stability perspective, either directly or through the more indirect channel described here. As always though, lenders will need to appropriately provision for any doubtful exposures, allowing for any deterioration in the outlook for the industry.