



## Plunging copper price sends Freeport McMoran in downward spiral

by [Dexter Tan](#)

Last week, copper prices hit a 6-year low, sending share prices of Freeport McMoRan (FCX), the world's largest publicly traded copper producer, to its lowest level since 2009. Coincident with the drop in market cap, the RMI-CRI 1-year Probability of Default (PD) for FCX increased sharply to 102bps, the highest level in more than two years. Struggling with the impact of lower commodity prices, Freeport McMoRan [announced](#) Wednesday that it would review its mining outputs and cut capital spending in its oil and gas operations.

FCX manages a global portfolio of mineral assets, including oil reserves in the North American region. The firm's financial results are dependent on the market prices of copper, oil, gold and molybdenum. During Q2, management guided that operating cash flows in 2H 2015 would approximate USD 190mn for each USD 0.10 per pound change in the average price of copper, USD 25mn for each USD 50 ounce change in the average price of gold, USD 60mn for each USD 2 per pound change in the average price of molybdenum and USD 55mn for each USD 5 per barrel change in the average Brent crude oil price.

In terms of sales, copper, oil, gold and molybdenum accounted for 65.3%, 16.5%, 10.2% and 4.8% of FCX's revenue, respectively. Regionally, North American copper mining operations generated 33.6% of sales, while similar operations in Indonesia, South America and Africa made up 12.8%, 12.0% and 6.9% of revenue, respectively.

The drop in copper prices came on the back of weaker economic growth in China, the world's largest consumer of refined copper. China's total imports of refined copper, according to Bloomberg, declined 10.7% from 1.88mn tonnes in 1H 2014 to 1.67mn tonnes in 1H 2015. Stockpiles tracked by the London Metals Exchange [climbed](#) to 352,325 tons, the highest since Jan 2014. Gold prices have declined markedly on [sluggish](#) demand from China and India, two of the world's largest consumers of gold, while crude oil prices have fallen in response to Iran's [plan](#) to increase oil production after sanctions were recently lifted against the country.

As seen in Table 1, Freeport McMoRan's earnings have been on a downward spiral. The recent commodity crash has punished the firm's bottom line but there are other headwinds affecting FCX's creditworthiness. Following its decision to pay top dollar to buy into oil assets in 2013, net income headed south afterwards in line with the sharp decline in oil prices.

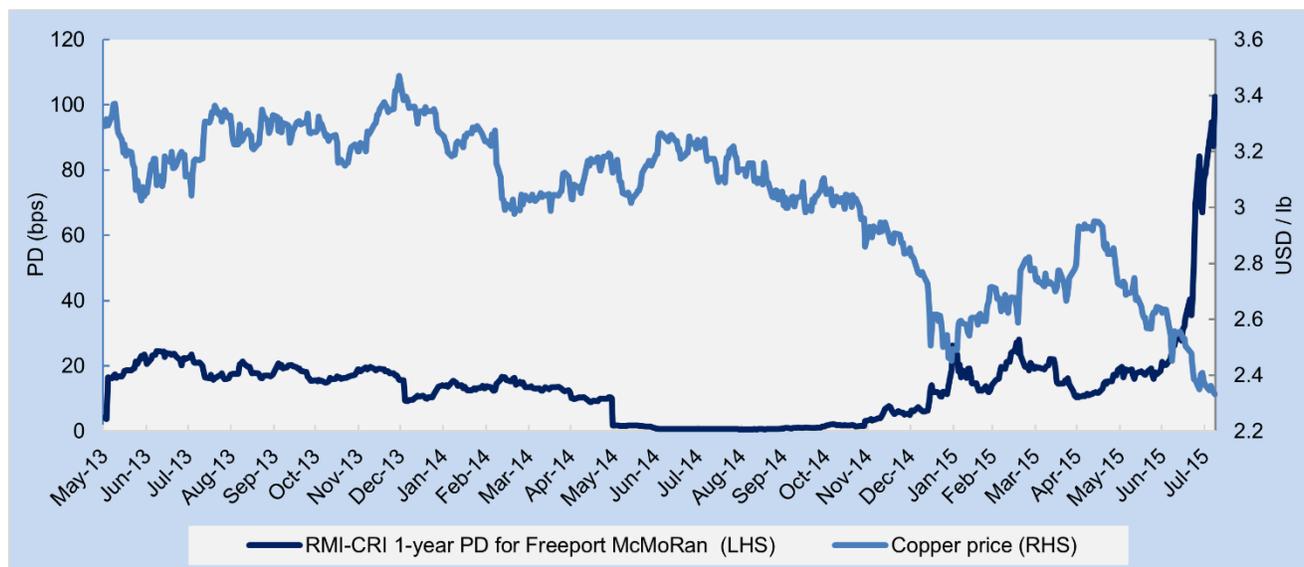


Figure 1: RMI-CRI 1-year PD for Freeport McMoRan vs Bloomberg CME generic 1-month copper futures prices. Source: RMI-CRI, Bloomberg

Uncertain rules and increased regulatory risk have played a part in a weaker credit profile for FCX. The Indonesian government, for one, has asked for more royalties and a greater interest in FCX's local operations. The miner will retain a smaller proportion of earnings from its key Indonesian asset after a partial sale of the company to the local authorities. FCX is likely to accept the authorities' further demands as the Grasberg mineral district is FCX's largest copper and gold asset and the firm has spent a significant amount of capital to develop the underground mines.

FCX conducts exploration and mining activities in Indonesia through a contract of works (COW) with the Indonesian government that expires in 2021. The current COW defines FCX's mining area as well as terms relating to taxes, exchange controls, royalties and other matters. In Jan 2014, the Indonesian government imposed a progressive export duty on copper and required all COW holders to obtain a six month license to export copper concentrates. Despite FCX's right to export copper without the payment of duties under the current COW, FCX was unable to obtain administrative approval for exports in the early half of 2014. As a result, operating income at the Grasberg mine dropped to USD 18mn in Q1 2014 and USD -67mn in Q2 2014.

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
<b>Net income</b>	510	482	552	-2,852	-2,474	-1,851
<b>Operating income at Grasberg mine</b>	18	-67	434	334	73	232
<b>Oil related impairment charges</b>			308	3,429	3,104	2,700

Table 1: Selected financial metrics for Freeport McMoRan. Figures are expressed in USD mn. *Source: Bloomberg, company reports*

On July 25, 2014, FCX signed a 1-year memorandum of understanding (MOU) with the Indonesian government under which both parties agreed to negotiate an amended COW. FCX resumed Indonesian exports in Aug 2014, but the allowance for exports came with a high price. Provisions being negotiated in an amended COW include the construction of a new copper smelting capacity in Indonesia, a potential 21% sale of FCX's Indonesian arm to the government at fair value and the rights to operate in the mines between 2022 and 2041. With the MOU in effect, FCX also provided a USD 115mn assurance bond for smelter development, increased royalties from 3.5% to 4% for copper sales and from 1% to 3.75% for gold sales, and agreed to pay export duties.

FCX's decision to move into the oil business was badly timed when WTI crude oil was averaging USD 110 per barrel. Oil has since dropped more than 50% to USD 44 per barrel. During Q2 2013, FCX paid USD 19bn to acquire Plains Exploration & Production Company and McMoRan Exploration Co, financing the three-way merger with USD 10bn in debt. Oil revenues dropped dramatically and a year later, FCX sold its Eagle Ford assets for USD 3.1bn to provide liquidity for debt repayments. In Jun 2015, the company announced plans to sell shares in its oil and gas unit through an initial public offering, offering investors as much as 19.9% of the business.

In addition to the heavy debt burden brought about by the oil asset acquisition, the impairment of oil gas properties has weighed upon FCX's credit profile. Net capitalized costs for FCX's oil and gas reserves between Q3 2013 and Q2 2015, have exceeded the ceiling amount under SEC full cost accounting rules, which resulted in massive impairment charges to operating income. The firm lost USD 3.7bn in 2014, USD 3.1bn in Q1 2015 and USD 2.7bn in Q2 2015 due to impairment expenses. What is possible is that the same scenario could replay itself if copper prices continue falling and remain depressed for an extended period of time, because of which FCX might be forced to write down its copper mining assets at the end of the year.

Maintaining a healthy balance sheet and credit standing is important to FCX as a downgrade of its credit rating could affect its requirement to provide financial assurance of its business performance under US state and federal mining laws. US permits, bonds and insurance are required to drill, plug and abandon wells. The Bureau of Ocean Energy Management and the Bureau of Safety and Environmental Enforcement regulations also require firms to have substantial US assets and net worth or prove that financial obligations will be met. These rules are required of mining firms so that miners may engage third parties to implement approved closure and reclamation works if they are unable to do so.

Moving forward, FCX is likely to cut production to reduce costs and to liquidate assets to improve free cash flows. Cutting production relieves operating costs but it also tightens the global supply of copper as FCX controls 8% of total worldwide mined copper production. As a matter of fact, the top 10 producers of copper comprise approximately half of total worldwide mined copper production and there were only four copper mines discovered in the past fifty years. This makes the discovery of a copper mine a very rare event. The consensus among forecasts is that copper prices will increase in 2016 but no one knows how much further it will fall before prices start to recover.

## Credit News

### Bad loans on the rise at China's commercial banks in second quarter

**Aug 11.** As China's decelerating economy continued to weigh on lenders, credit risks across the commercial banking sector are beginning to emerge. In the second quarter this year, the amount of non-performing loans reached CNY 1.09tn. According to the China Banking Regulatory Commission, the average bad loan ratio of the sector leapt 0.11% to 1.5% at the end of June. As more loans turned sour, China's incumbent commercial banks set aside more cash. Loan loss reserves at the end of the second quarter amounted to CNY 2.17tn, an increase of CNY 83.5bn over the end of the first quarter. Their credit risks were increased further as banks' profit growth in H1 also slowed by 13.03% YoY, which will reduce shareholder return, weaken banks' capability to supplement capital and prevent risks. ([SCMP](#))

### Debt loads grow for Australian miners

**Aug 10.** Australian and Canadian miners are struggling with their debt repayments due to shifting currency markets, which are driving up the cost of repayments particularly to US creditors. When commodity prices ran hot in recent years, many Australian mining companies reached out to lenders in the US, where they were able to get fresh capital at highly attractive rates. Now, with the AUD down sharply against the USD, the cheaper loans they accessed have gotten considerably more expensive. A rise in US interest rates, near zero for more than six years now, would likely add to the difficulties for miners with US-denominated debt and AUD balance sheets. ([WSJ](#))

### US bankruptcy filings jump 77% in July, paced by energy sector

**Aug 6.** Newly released numbers from Epiq Systems showed that chapter 11 filings rose 77% in July. There were 637 filings last month, compared with 359 at the same time last year. It is the highest number of monthly new chapter 11 filings in nearly three years. Most of the increase in filings has been driven by distress in the energy sector. However, companies from other sectors have also populated the list of bankruptcy filers last month. There were also a number of headline-grabbing filings last month. ([WSJ](#))

### ANZ plans AUD 3bn share raising to meet capital rules

**Aug 6.** Australia & New Zealand Banking Group Ltd. is raising AUD 3bn in capital following moves by regulators to make Australian banks safer, taking equity issuances by the country's largest lenders to the highest since the global financial crisis. The raising will add about 78bps to the lender's common equity Tier 1 capital ratio, taking the measure to 9.3 percent. ANZ will have to revise its previous target of reaching a 16% return on equity by 2016, as the capital increase makes the goal "meaningless," the bank's chief executive officer Mike Smith said. ([Straits Times](#))

### Ukraine's debt faces 'high risks': IMF

**Aug 5.** The IMF, which recently released a loan instalment for Ukraine, said on Tuesday it views the country's debt as sustainable but facing "exceptionally high" risks linked notably to the conflict with Russia. IMF, in a report on Ukraine's USD 17.5bn loan program awarded in March, highlighted the government's progress in implementing required reforms, putting the economy on a tentative track to stabilization. In its report, the IMF signaled concern about the country's debt burden, which it expects will approach 100 percent of GDP this year amid the country's deep recession, now forecast at a 9 percent contraction. The Ukrainian debt outlook could suffer from "prolongation of the discussions on the debt operation" and "larger-than-expected financing needs of the banking sector," the report said. ([Channel News Asia](#))

**Fears of financial crisis rise as Russia's economy shrinks** ([FT](#))

**Tesla stock falls on wider loss, CEO comments on cash need** ([Reuters](#))

**Noble fully redeems USD 735mn worth of bonds** ([Straits Time](#))

### **Regulatory Updates**

#### **US regulators said to step up scrutiny of fund liquidity**

**Aug 7.** US financial regulators are stepping up inquiries into how debt-buying funds handle liquidity and redemption risk as the central bank moves closer to raising interest rates for the first time in nine years. Regulators are particularly concerned about debt markets where trades take longer to complete, including leveraged loans which often take seven days or more to settle. They worried that funds which invested in the hard-to-sell securities may struggle if the bond rally ends and investors seek to withdraw their money all at once. Regulators' closer scrutiny would hopefully prompt more efforts to fortify funds and ensure that fund managers are prepared for an exodus of investors. ([Bloomberg](#))

#### **China securities regulator to crack down on illegal fundraising via Internet**

**Aug 7.** The China Securities Regulatory Commission (CSRC) announced on Friday that they would launch a nationwide crackdown on equity financing through the Internet and would also step up regulations on crowdfunding, which consists of raising money via contributions for SMEs from a large pool of people, mostly done online. As crowdfunding involves public interest and China's financial stability, most crowdfunding sites are banned in the country. Institutions in China, however, are allowed to raise capital via the Internet from no more than 200 select investors, and CSRC, in its special investigation, will make sure rules are not violated, according to the regulator. ([The Business Times](#))

#### **Europe's ABS market boost hinges on inducing insurers to buy**

**Aug 6.** Hoping to free up capital, boost lending, especially to small companies, and spur economic growth, European Union and global regulators recently proposed softening criteria for identifying simple and transparent securitizations that could qualify for preferential regulatory treatment. Analysts said that this push to promote asset-backed securities is contingent on their ability to persuade insurers to buy the debt by easing capital requirements of the EU insurance law, known as Solvency II. They said that the capital relief offered by Solvency II for "high-quality" securitizations is not enough. ([Bloomberg](#))

**Basel IV is the buzzword as Europe's banks brace for costs** ([Bloomberg](#))

**SEC forces US companies to reveal CEO's versus workers' pay** ([Sydney Morning Herald](#))