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Mining contractors feel the pinch with cost cutting

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'The real downturn is going to be when the major LNG projects finish construction,' PPB Advisory head of resources Campbell Jaski warns. Picture: Colin Murty Source: TheAustralian

THERE had been plenty of signs that all was not well for Australia's mining contractors, but it was the $1.4 billion wipe-out at WorleyParsons this week which really reminded investors of the bleeding that is still taking place.

The support industry faces a perfect storm of difficult problems

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WorleyParsons was smashed after it cut its profit guidance for the second time this year, adding to a wave of downgrades in recent weeks by contractors including Ausdrill, Sedgman, Monadelphous, Bradken and Forge Group.

The pain being felt across the sector stems from a combination of unfavourable factors. Mining companies have for the past year been taking a ruthless approach to cost cutting, and contractors who had seen their margins steadily increase over the course of the mining construction boom have been an easy target.

Compounding the issue has been a steep drop in approvals for new projects and expansions. A services sector that had grown accustomed to ever-expanding demand now finds itself competing for a rapidly shrinking pool of work.

Then there is the emerging trend among miners big and small to switch away from contractors in favour of moving operations in-house. The likes of BHP Billiton, Glencore Xstrata and Peabody Energy have all removed contractors from certain mines, reversing a longstanding trend towards outsourcing at the worst possible time for the contractors.

For Simon Fitzgerald, an analyst at Moelis & Co, the key problem facing the mining services sector and particularly those groups heavily exposed to construction, rather than operations, is reflected in one chart from BHP Billiton's annual results presentation earlier this year.

The chart, which plots BHP's forecast capital expenditure out to 2016, shows a steep drop in the coming years -- a trend Mr Fitzgerald says will be reflected in the broader mining industry.

Groups like WorleyParsons, which specialises in engineering and construction, will face continued pressure as a result.

"Worley are very project-exposed," Mr Fitzgerald said.

"It needs big, long construction projects to kick off if it's to keep growing, but those sorts of projects are getting cancelled and deferred."

One curious phenomenon to emerge out of the current climate, says PPB Advisory head of resources Campbell Jaski, has been a push from mining contractors for detailed due diligence of their clients.

That, he says, has been driven by the mining contractors' lenders, who have become increasingly concerned about the ability of the contractors to service their debts.

Such is the desperation of other contractors, he says, they are rushing headlong into marginal new contracts which could prove troublesome in the future.

The alternative of selling surplus equipment on the second-hand market is also unappealing, given the glut of equipment available and the lack of buyers.

Another emerging trend, particularly for drilling companies struck by the sharp drop in exploration activity, is to carry out work for cash-poor clients from the junior end of the market in exchange for shares.

"It works from the junior's point of view because they're cash-constrained, they don't have the money to go out and explore, but at the same time they can't raise capital and progress their projects without drilling," he said.

"The shares may be worth something one day (to the contractor), but really it's about keeping the rigs going and keeping the crews together."

In the mining industry itself, there is some anticipation about the bottom-line boost that the troubles in the mining services sector may deliver.

Morgan Ball, the managing director of iron ore miner BC Iron, says plenty of contractors that wouldn't have bothered with the company in the past have been knocking on his door in recent months looking for work.

"In that space people are really interested to talk to us, more so than they may have been a couple of years ago," he told The Weekend Australian.

"That's partly about us as a company, and partly because there was so much other work out there."

Unfortunately for Mr Ball and BC Iron, the company is still committed to contracts it signed a couple of years ago.

"Now would be a lovely time to be retendering work but that's not the case for us," he said.

Worryingly, there are expectations that conditions in the services sector may get even worse before they get better.

First, there's the huge capacity that was built up in the sector during an unprecedented construction boom that now needs to find a home.

"Getting all that capacity up over the last four or five years has meant there's been an overinvestment in mining services companies to allow that expansion to happen. Now we've got excess capacity," Mr Jaski said.

On top of that, the current conditions are likely to be further compounded in the wake of Australia's $200bn-plus LNG construction boom. "We've had quite a volatile period as a result of the downturn in the mining sector but the real downturn is going to be in the next two-three years when the major LNG projects finish construction," Mr Jaski said.

"That's going to be when there's going to be a huge amount of mining services companies suddenly losing those revenue streams."

The great hope for the industry is a ramp-up in infrastructure spending by federal and state governments around Australia.

But Mr Jaski says expectations such spending can make up for the work that will disappear with the end of the LNG construction boom are wishful thinking. "People are waiting for the government to chip in with some massive infrastructure spending, because that's the only thing that can possibly help cushion the drop in construction spending that will come out of the LNG projects," he said. "There will be some infrastructure spending but it won't be anywhere near the levels we've seen."