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Petra Diamonds affected by abrupt changes in its operating environment

by Samuel Chee

On July 10, 2017, an announcement with regards to a series of regulatory changes in Tanzania rocked the mining industry, potentially making it more difficult to carry out mining operations in the East African country. Under the new regulations, royalty fees on exported minerals and metals were raised, eating into profits of the mining companies. More crucially, the government also imposed an export ban on mineral concentrates and selected metallic ores. The regulatory changes created waves, generating huge reactions from the mining industry. Shanta Gold Ltd backed out of its agreement to acquire Helio Resources Corp's gold project in Tanzania, citing the regulatory changes as the key reason behind its action. Acacia Mining PLC suffered heavily due to the enforcement of export bans on its gold and copper concentrate, running into legal issues. Petra Diamonds Ltd, a diamond mining company with operations in Tanzania and South African, was also affected by the policy changes as well, with warnings of its inability to meet key debt covenants surfacing after the company forecasts poorer financial performance. The regulatory changes made the business environment tougher for these mining companies, which is evident from the large drop in operating cash flow for these mining companies (see Table 1).

Operating Cash Flow (mn USD) for the period ended	2016/12/31	2017/06/30	2017/12/31
Petra Diamonds Ltd	78.8	73.7	23.9
Shanta Gold Ltd	13.7	22.1	2.2
Acacia Ming PLC	160.9	1.3	-24.3

Table 1: Operating Cash Flow for selected mining companies. *Source: Bloomberg*

In Petra's case, a consignment of diamonds was seized by the Tanzanian government last September after the shipment was judged to be undervalued, which affected the amount of royalty payments made to the officials. Due to the export ban, Petra was unable to sell them at its overseas marketing facility, cutting off the revenue stream. If remained unsolved, this problem would make it difficult for the company to sustain its operations in Tanzania. As such, Petra had to resort to a temporary 4-day closure of its Williamson mine whilst the company assessed the situation.

Adding on to problems faced in Tanzania, Petra also encountered a series of labor unrest in September last year, causing disruption to some of its operating segments in South Africa. The company had to re-negotiate work contracts with improved salary packages when the workers went on strike. Petra also acknowledged the underperformance of a couple of its South African mining facilities, which was followed by an impairment of USD 118mn made on its Koffiefontein and Kimberley mines. In terms of financials, Petra saw its operating margin decrease consecutively from the end of 2016. Net Debt/Equity ratio increased over the past few semiannual periods, of which 2017 S2 showed a sharp rise in its Total Debt/Trailing 12-month EBITDA. The appreciation of the South African Rand together with the company's worsening profitability contributed to the plunge in Petra's Interest Coverage Ratio, pointing to a possible decrease in ability to service its future debt obligations.

	2016/12/31	2017/06/30	2017/12/31
Net Debt/Equity (%)	73.67	101.01	110.82
Total Debt/Trailing 12-month EBITDA (X)	2.48	5.45	25.18
Interest Coverage Ratio (X)	6.95	1.26	-4.56
Operating Margin (%)	26.48	6.29	-35.83

Table 2: Financial Data for Petra Diamonds Ltd. *Source: Bloomberg*

Taking into account Petra's weakening financial figures and a large drop in its market capitalization, Petra's RMI-CRI Probability of Default (PD) saw a substantial increase over the past 12 months (see Figure 1).

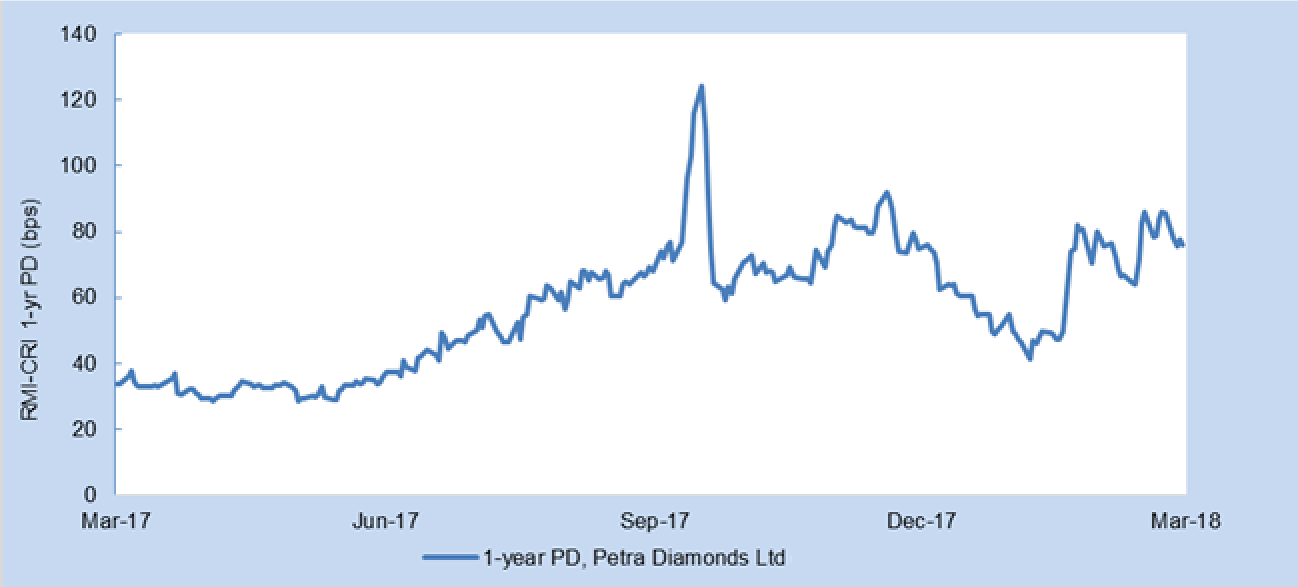

Figure 1: RMI-CRI 1-year PD for Petra Diamonds Ltd. *Source: RMI-CRI*

On February 18, 2018, there was a silver lining for Petra when it announced that it had managed to receive waivers from its lenders for the debt covenants for December 2017. However, the key covenant tests are conducted twice annually and it remains to be seen if Petra will be fortunate enough to receive further waivers, if needed, for 2018. Petra was also helped by the fact that large portion of its debts are long-term with the year 2022 being the earliest of maturities. However, repeated profit warnings, such as the most recent one issued in Jan 2018, signaled Petra's decreasing ability to stabilize its revenue streams. Therefore, it is crucial that Petra find a way to overcome the issues faced in Africa.

Petra, as with other mining companies, operates in a capital-intensive industry with high barriers to entry. These companies often require a large initial investment which often results in taking on loans or issuing debts. Those who are imprudent may experience a drop in creditworthiness when debts accumulate. Evident from the events in Tanzania and South Africa, a drastic change in operating environment can cause huge difficulties for the companies involved. Thus, Petra and its other industry players will need to adapt to these unforeseen changes or risk being excavated from the industry.

Credit News

South Africa's VBS Mutual Bank fails amid liquidity crisis

Mar 11. VBS Mutual Bank (VBS), one of South Africa's smallest lenders, has been put into administration after it was unable to repay money owed to municipalities, according to the country's central bank. 18 months ago, VBS accepted increasing amount of municipal deposits and made the risky move of lending it long term. When the municipalities came asking for that money on Feb 16, 2018, VBS was unable to produce it. Although VBS was asked to develop a plan, it became clear that its major shareholders would not be able to repay within a short period. Thereafter, VBS has to face the solution of curatorship because of this severe liquidity crisis. VBS's total assets were ZAR 2.4bn by the end of 2017. The South Africa Reserve Bank said that retail depositors' money is guaranteed and VBS will stay open. (Bloomberg)

Claire's bankruptcy would accompany a shift away from malls

Mar 10. Claire's Stores Inc. is shifting its business arenas away from malls to supermarkets and drugstores while closing on its Chapter 11 bankruptcy deal on March 8. The accessories retailer has been struggling with its USD 2bn debt originating from Apollo's leveraged buyout in 2007, which is 10 times more than its annual earnings. Other than pressures from its USD 1.4bn of debt maturing next year and USD 60mn of interest due on March 13, the company's depleting revenue from slowing foot traffic at many US malls has forced it to expand its arenas to local drugstores and supermarkets, a significant change from the enclosed suburban malls it was usually associated with. At the moment, Claire has made partnership deals with Giant Eagle supermarket and CVS drugstore and is seeking for more collaborations within these arenas to generate meaningful growth. (Bloomberg)

Toys 'R' Us said to prepare for shutdown of US operations

Mar 9. Toys 'R' Us Inc. is preparing for a liquidation of its bankrupt US operations after failing to reach a debt restructuring deal with lenders. Although the shutdown of US operations has not been confirmed, hopes that a buyer will emerge are fading. The toy chain declared bankruptcy in September 2017 with plans to renew its business model and emerge with manageable debts. However, its USD 3.1bn loan to keep the stores open during the turnaround period turned out to be a backlash as sales during holiday period did not turn out as expected. The current condition has generated detrimental effects for many of the retailer's overseas division. Plans to offload its Asia unit, the most profitable arm of the company, were discussed while it remains unclear what will happen to the Canadian unit. (Bloomberg)

South Korea to offer USD 225mn loan to ease hit from GM fallout, corp restructuring

Mar 8. On March 8, 2018, South Korea announced to offer about USD 225mn in loan guarantees and low-interest loans to regions hit by GM’s corporate restructuring. A total of 395 subcontractors, including small business owners and workers of Gunsan and Tongyeong, are eligible for support. Out of the USD 225mn loan, nearly 54.17% is embarked for loan guarantees for subcontractors, about 20.83% for low-interest loans for small business owners and the balance 25% for special loan guarantees. According to the Ministry of Trade, the crises that take up a large portion pf regional economy has raised concern about the increased dangers of unemployment and subcontractors’ financial difficulties. (Reuters)

Kenya Airways looks upmarket for financial salvation

Mar 6. After taking the helm in June 2017, Kenya Airways CEO is targeting higher paying customers to revive the loss-making business. The company reported five years of annual losses before it restructured its debt in exchange for equity. The government owns 48.9 percent of the company and provided guarantees to the airline’s debts. The carrier faces intense competition from other African airlines as it launches new routes from the United States. Kenya Airways reported an operating profit in 2017 but financing costs were nearly nine times that amount. (Reuters)

Blockbuster CVS sale masks turmoil in corporate bond market (Bloomberg)

Noble fails to make coupon payment on March 9; to sell vessel for USD 24mn (Business Times)

Lehman to pay USD 2.4bn to end crisis-era mortgage claims (Bloomberg)

Regulatory Updates

BIS tells central banks to keep calm and carry on with policy normalization

Mar 12. According to the Bank for International Settlements (BIS), the recent volatility in global financial markets should not deter top central banks from increasing interest rates or ending years of unprecedented stimulus. BIS’s latest report said that after such a long period of calm, there were bound to be more market wobbles, but policymakers need not have to fear such volatility along the normalization path. Even though the recent market correction wiped trillions of dollars off the value of global stocks, the turbulence has not alter the broader economic and financial picture. Financial conditions remain unusually accommodative and credit markets have hardly budged. (Reuters)

EU body strikes back at cryptocurrency

Mar 9. Andrea Enria, the chief executive of the European Banking Authority has pushed back calls to regulate cryptocurrencies, stating that it would be more effective to prohibit financial institutions from holding and selling cryptocurrencies. Regulating fintech cryptocurrency firms would risk excessively constraining financial innovation as start-ups do not have the resources to shoulder the compliance burden. Fintech regulation in Europe should keep pace with laws in the US and China and be restricted to companies that are performing the same functions as banks. (FT)

ECB drops pledge to buy more bonds if needed (FT)

China regulator to cut banks' bad debt buffers (Reuters)

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