SE Exclusive

HD **Glencore has fighting chance of completing rumored Rio Tinto merger**

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Industry commentators have a bit to say on the rumors surrounding a potential merger between Glencore Plc and Rio Tinto, and there is suggestion that it would not take much for Glencore to get a potential deal off the ground.

Bernstein Research senior analyst Paul Gait told institutional investors during an Oct. 7 conference call that it appears to be an "eminently doable kind of deal."

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Meanwhile, Fat Prophets analyst David Lennox told SNL Metals & **Mining** that Glencore would have a good starting base for a possible merger if it is able to convince Rio Tinto's largest shareholder, Aluminum Corp. of **China**, or **Chinalco**, to sell its 9.8% **stake** in the **company**.

While both Glencore and Rio Tinto have hosed down speculation that the pair are in fresh talks regarding a possible deal, Glencore did not completely close the door on the option, saying Oct. 7 that it reserves its rights to make an offer in the future.

Glencore contacted Rio Tinto in July regarding a potential US$160 **billion** merger of the two companies. However, Rio Tinto knocked back the offer, saying it was not in the best interests of its shareholders.

Overall, the consensus seems to be that a merger between the two companies makes sense and would be positive for the **mining** industry.

Gait said a merger would essentially give the world's best **mining** real estate to the management that has the most coherent and well-articulated strategic vision for the **mining** industry.

"It would essentially enable the **company** to create the world's largest must-own **mining** stock, with all of those kinds of rerating potentials inherent in that, and at the same time the deal would be earnings accretive," he said. "So what's not to like from an industrial perspective in putting these two companies together?"

According to Gait, a merged Rio Tinto and Glencore would displace BHP Billiton as the "must-own" **mining** stock.

"You would have in NewCo, pretty much the perfect **mining company** from a commodity exposure perspective," he said. "You would have all of the major commodities covered — **copper**, **iron ore**, **coal**, nickel, zinc — as well as having significant optionality around some of the other minor commodities — the ferroalloys and so on and so forth."

Citi said in a research note to clients, cited by The Australian on Oct. 7, that it is a positive potential deal for Glencore and for the sector given the long list of potential rationales.

"The big question is at what price would Rio shareholders agree, if at all, given we are at the lows of **iron ore** prices based on our house view," Citi said.

Lennox agreed it would come down to dollars and cents and what Glencore is willing to offer to effect a merger.

"It would obviously have to be an offer that would show value greater than what shareholders think that the current structure of Rio Tinto could deliver and that's really going to be the key," he said.

An attractive target

The lure of Rio Tinto for Glencore is extremely high given the recent volatility in the **iron ore** price and the impact this has had on Rio Tinto's share price.

"Rio Tinto is now looking about as cheap as it ever has from a Glencore perspective," Bernstein's Gait said.

The **company** has lost nearly 20% of its relative value compared to Glencore over the past few months as the **iron ore** price hit fresh five-year lows of less than US$80 a tonne.

The long-term price outlook for the steelmaking ingredient is also grim, with analysts forecasting a price of less than US$100 a tonne.

However, the expectation for base metals is well-supported, according to Gait, with **copper**, zinc and nickel all forecast to rise.

"If we look at the average commodity portfolio, so the average price that the Rio Tinto portfolio is exposed to, that is basically going to trade flat, [with] some growth in aluminum and **copper** offsetting the very significant declines in **iron ore**," Gait said.

"On the other hand, if we look at what Glencore is exposed to, it's essentially thermal **coal**, zinc, nickel and **copper** — commodities everybody expects to do well into the medium and long term, and it's this that has given rise to the disparity between both the multiple that the companies trade on and also the recent share price performance."

J.P.MorganCazenove also sees the "credible strategic rationale" behind a combination of the two companies.

Analysts said in a note cited by Mineweb on Oct. 7 that Glencore's approach to Rio Tinto in July affirmed its view that Glencore has a "strategic appetite" to pursue a tie-up with Rio Tinto.

"In our view, [Glencore's] management are attracted by the physical commodity trading opportunities potentially afforded by [Rio Tinto's] **iron ore** business, a commodity where [Glencore] has negligible exposure," analysts said.

Positives outweigh negatives

Fat Prophet's Lennox said a combination of the two companies would give Glencore greater exposure to actual **mining operations**, while at the same time lowering the **company**'s trading exposure inside its own **operations**.

He also noted that Rio Tinto has a very strong balance sheet, which could be leveraged up prior to any merger, and very strong cash flows, and that any merger would give Glencore significant exposure to key commodities, particularly **iron ore**.

"Not only would they be a significant miner of **iron ore**, but they would be a significant trading house in it," Lennox said. "That would really complement their trading business. From Glencore's point of view, you can probably see why they've been sniffing around [**Chinalco**]."

Any potential deal would see better management of Rio Tinto's **iron ore** business, which could enhance the value of the **company**'s Pilbara assets, according to Gait.

"I think for me, it's painfully clear that the strategies of the large **iron ore** majors have not worked," he told institutional investors. "For every 1% additional volume growth that we're pushing into the market, the price of **iron ore** comes down by about 2%.

"This is not value-maximizing, it's not even earnings-accretive, let alone value-maximizing, and the better management of the **iron ore** industry would mean that for every [US]$1 a tonne of improved price on the back of superior capital discipline, the value of the Pilbara assets goes up by about [US]$1.5 **billion**."

A merger could also allow for the acceleration of around US$50 **billion** in capital returns through the more aggressive use of Rio Tinto's balance sheet, as well as deliver a possible US$35 **billion** rerating of the **company**.

Possible offer price

Among the questions surrounding potential merger rumors is the price Glencore would pay for Rio Tinto, and some believe a substantial premium would not be on the table and any bid would likely be a mix of cash and scrip.

Gait suggests Glencore may consider up to a 20% premium via an offer of £16.40 and 6.3 shares for every Rio Tinto share held.

"I think the most likely situation rather would probably be to see more paper than that involved in any offer, but there is certainly a very significant potential for a cash element in any deal," he said.

Meanwhile, another big question is whether or not **Chinalco** would consider any offer put forward by Glencore.

Media reports that say Glencore has been sounding out Rio Tinto's shareholders as a precursor to a possible merger has many speculating whether major shareholder **Chinalco** will even look at a potential bid.

Fat Prophet's Lennox thinks **Chinalco** would be more interested in a share deal.

Meanwhile, Bernstein's Gait surmises that the **Chinese** aluminum major may be frustrated by the lack of progress with Rio Tinto's Simandou **iron ore** project in Guinea, the development of which was one of the reasons **Chinalco** invested in the major **mining** house.

"**Chinalco** paid £60 a share to buy its 9.8% **stake** in Rio Tinto and that was predicated on essentially the development of the Simandou project and greater board representation for **Chinalco**, neither of which have really progressed," he said.

"One of the issues that we're dealing with here is, essentially, **Chinalco** may be very frustrated with the amount of progress that has been made so far and would in actual fact like to see a further development of Simandou.

"It is entirely possible that Glencore could make the decision simply to give those tenements to **Chinalco** as a condition for their support for the deal."

While many believe Glencore stands a good chance of completing a merger deal and can see the strategic rationale behind such a combination, J.P. MorganCazenove analysts are of the view that a tie-up is unlikely in fiscal 2015.

Rio Tinto has now reportedly turned to Macquarie Group for assistance in protecting itself against any potential bid by Glencore.

Sources told The Australian Financial Review that Macquarie would retain a role focused on maximizing "shareholder value" in the event that Glencore makes a another push to create the world's largest **mining** house in 2015.

CO almcor : Aluminium Corporation of China Limited | march : Glencore PLC | rtz : Rio Tinto PLC | rtzcra : Rio Tinto Group | craaus : Rio Tinto Ltd

IN i211 : Metal Ore Mining | ibasicm : Basic Materials/Resources | imet : Mining/Quarrying | i22 : Primary Metals | i224 : Non-ferrous Metals | i2245 : Aluminum | i8396 : Diversified Holding Companies | ibcs : Business/Consumer Services

NS cmerg : Mergers | c18 : Ownership Changes | c181 : Acquisitions/Mergers/Takeovers | cacqu : Acquisitions | cactio : Corporate Actions | ccat : Corporate/Industrial News | ncat : Content Types | nfact : Factiva Filters | nfcpin : C&E Industry News Filter

RE austr : Australia | apacz : Asia Pacific | ausnz : Australia/Oceania

IPD Rumored Transaction

PUB SNL Financial LC

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