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HD **Mega merger gets Bernstein nod**

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It feels a awful lot like Ivan Glasenberg has been out and about again.

For some time there has been speculation effervescing through big **mining** that Glencore's enamel-hard chief executive has eyes for a tectonic takeover that would complete the Baar-based commodity trader's transition into the world's most diversified miner.

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Now, for a guy who runs a massively complicated and successful marketing business that remains opaque enough to be dubbed a "black box" in one contemporary analyst note, Glasenberg has proven cheerfully public with his upstream thought bubbles. This year alone the South African-born Australian citizen, who runs a Swiss conglomerate from London, has made announcements on behalf of his major cousins BHP Billiton and Rio Tinto.

Back in March, Glasenberg revealed, in almost one breath, that Glencore had been in discussions with Rio about a merger of their respective Hunter Valley thermal **coal operations** and that it was kicking the tires on BHP's troublesome Nickel West business. Needless to say, this protocol busting did not go down well with either of the Anglo-Australians.

Now, if we are to believe the gathering chatter, Glasenberg has set his acquisitive gaze on Rio Tinto. And this tentative but persistent conversation has now been punctuated by a note published by Bernstein Research. It highlights the logic of a Glencore-Rio alliance above pretty much anything else Glasenberg might do. A daunting propositionThe simple but daunting Bernstein proposition is that $US80 **billion** ($89 **billion**) Glencore should make a premium, scrip and cash offer for $US110 **billion**Rio Tinto.

An alternative would be for Glencore to go after Anglo-American. But the advice is that we should believe Glasenberg's consistent advice that he has no interest in making that happen. Rio, on the other hand, is the "biggest possible fish" in global **mining** and one that would deliver Glasenberg to a seat of matching, but thoroughly different, power to current resources kingpin, BHP. And, given it marched to the Bernstein beat, the new Glencore would promptly become **mining**'s must-own stock.

"A Rio Tinto-Glencore combination would create market-leading positions in **iron ore**, **copper**, nickel, zinc and **coal** as well as significant optionality around a number of lesser metals and minerals," Bernstein's London-based senior analyst, Paul Gait, writes.

"Moreover, it would create the biggest and most diversified **mining company** on the planet. It would be a Glencore-Rio combination that would quickly become the 'must-own' stock for anyone looking for **mining** exposure.

For as long as BHP Billiton wore that mantle they were rewarded with a premium valuation. A re-rating on the combined **company** EBITDA could deliver a value uplift of ~$US35 **billion**," he wrote.

That may, of course, be quite true. But, just as it is true that Glasenberg has floated the potential of his dream team, so it would be accurate to suggest that Rio is treating this whole, odd discussion with cautious disdain. Few inside or outside Rio believe a deal would be possible or particularly advisable. Not only are synergies hard to identify outside of the operational overlap of Australian thermal coal but there is a conviction that governments across a great host of the new and old commodity economies would take a very dim view of the while thing.Concern of regulators

The history of mining mega-mergers is not encouraging. Where miners identify shape-shifting synergy and value creation, regulators from Brussels to Beijing have seen only unacceptable consolidation, reduced competition and increased market power.

Before it was finally undone by the global financial crisis in November 2008, BHP's contested pitch for Rio was delayed and fiercely redrafted by the European competition regulators. And the subsequent proposal to form a national iron ore champion with the agreed merger of BHP and Rio's Pilbara iron ore arms was, in the end, scuttled by regulatory resistance in China, Europe and even Australia. Here, rather famously, the ACCC could not find its way to clearance even though it had green-lighted the original takeover. Go figure!

Glasenberg has recent experience of the reach and power of competition regulators. The only way he was able to complete the $US64 billion takeover of Xstrata was by selling the company's best copper asset, Las Bambas in Peru. That disposal was forced on Glencore by China's competition regulator.

But these issues don't seem to cloud the Bernstein view. And the reason we think this is important is that we are guessing this work, to some degree, is channelling Glasenberg.

That might, for example, explain Gait's cake-and-eat-it-too moments. He applauds the rescue of Rio's tarnished balance sheet and reputation by chief executive Sam Walsh. But he identifies a triptych of strategic problems that are "eminently fixable" but apparently not by Rio management present or future.

While highlighting the emerging fragility of Rio's iron ore strategy he also writes that the risks generated by the miner's "unbalanced" portfolio have been overblown. He then suggests that, under Glencore's direction, Australia's biggest iron ore business could carry a whole lot more debt. Going into high gearThe data suggests Glencore is content to carry a higher level of gearing that Rio. It boasts a 25 per cent EBITDA margin from mining assets. And they are geared at 2.9-times net debt to gross earnings. Rio Tinto, on the other hand, generates a 42 per cent margin while gearing sits at under 1 times net debt to earnings.

"If the combined entity were to accept the same level of financial gearing as Glencore today (and it should be able to support more, not less, given the improvement in operational gearing) a surplus $US49 billion of cash could be liberated from the balance sheet.

"This would give Glencore the ability to use cash for a significant part of any acquisition consideration," Gait muses. Oh and what are Rio's big three problems? Apparently, that the world now has too much iron ore; that Rio's management has failed to "understand the different between portfolio and incremental economics; and that its share price is "too cheap".

So what is the answer to all that?

"All that [is] required is to hand the world's best mining assets to the world's best management – and Glencore are making a pretty strong case that they, more than anyone else, understand what it will take to drive value in today's market."

It has to be said, this is a pretty big call.First off, as the Bernstein note acknowledges, Rio Tinto has outperformed Glencore since its IPO in May 2011. And second, the starting point for any meaningful analysis of effective management in mining is safety. And it is a fact tragically unavoidable that Glencore has an unacceptable recent record of work place fatalities.Safety doesn't equal management

Glencore has set about taking global the safety programs designed for, and installed in, its Australian coal operations. But its safety record simply does not sustains any claims of management pre-eminence. And the company well knows this.

To be fair, the Bernstein view is coloured mostly by a conviction that Glencore has a clearer focus on what shareholders really want: capital discipline which translates in greater returns. And the best people to deliver that are the rational economists that drive the likes of Glencore rather than the operationally focused engineers that drive the likes of BHP.

With that Bernstein's Gait wonders what will happen to Rio when the Walsh era of rationality comes to its end. "What is Rio Tinto's strategic identity in a world of slowing iron ore demand? What will be the strategic direction of Mr Walsh's successor? Will he recognise the changing nature of Rio Tinto's business or will he repeat the mistakes that almost brought about the demise of the **company** in 2008 in a search for growth everlasting and commodity diversification?" Gait asks.

We can answer some of the questions. Rio will be the biggest and lowest-cost producer in global **iron ore** that will generate margins of 50 per cent even at circa $US80 a tonne. Walsh's retirement will unlikely inspire strategic change given it is tipped CFO Chris Lynch will get the nod and he has walked in lockstep with the boss since the recovery mission started last year. And, no, dark history will never be repeated.

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