HD Beijing Will Call The Shots In Resource Sector Battle Royal

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Michael Komesaroff is principal of Urandaline Investments (www.urandaline.com.au), a consultancy specializing in China's capital-intensive industries In October the world's fourth largest mining company, Glencore, launched an audacious merger bid for the world's second biggest miner, Rio Tinto. The approach was rebuffed, and United Kingdom takeover rules?both companies have London listings?forbid Glencore from making any further overtures for the following six months. Yet few in the mining business believe that is the end of the story. Glencore's chief executive officer Ivan Glasenberg has long had his eye on Rio Tinto. Come April, industry analysts expect him to be back with a new proposal. However, any battle over Rio Tinto will be about far more than Glasenberg's deal-making prowess. It will shape the global mining industry in the post-commodity-boom world.

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And the outcome will be determined in large part by Beijing, whose anti-monopoly regulators have shown themselves both willing and able to use their growing international clout to further China's global resource strategies by forcing the sale of prize assets like copper mines to Chinese state-owned companies. That means a successful Glencore bid for Rio Tinto will almost certainly end in the dismemberment of the Anglo-Australian giant that has dominated the global mining scene for over a century, with Chinese state-owned resource companies cherry-picking many of the company's choicest businesses. Catastrophic business decisions Beijing has a stake in the fate of Rio Tinto not only as the miner's main customer but also as its biggest investor. In 2008 state-owned behemoth Aluminum Corporation of China, or Chinalco, paid £60 a share for 9.8% of Rio Tinto, becoming the company's largest shareholder. Since then Chinalco has seen the value of its investment severely eroded following a series of catastrophic business decisions by Rio's senior management. The problems date back to 2007, shortly before Chinalco bought in, when Rio Tinto outbid other competitors by US$10bn to acquire the Canadian aluminum giant Alcan Inc. for US$38bn. This remains the world's largest all cash mining deal but the acquisition has not gone smoothly. Rio Tinto badly underestimated the competition from the unrestrained expansion of Chinese aluminum producers, which have flooded the market with their metal, depressing aluminum prices and forcing Rio Tinto's management to write down two-thirds of its original investment. The Alcan purchase was not Rio's only disastrous acquisition. In 2011 the company paid US$3.7bn for a coal mine in Mozambique which was subsequently written down and sold for a mere US$50mn. Following the write-offs, in 2013 Rio Tinto edged out its chief executive, Tom Albanese, along with a clutch of other executives responsible for the valuedestroying acquisition program, replacing them with a new line-up headed by Sam Walsh. The new management team was charged with refocusing the company by cutting costs, disposing of underperforming assets and restoring the capital discipline that had previously been Rio Tinto's hallmark. Walsh, who had come from the company's iron ore division was seen by the market as the right man to cut the bloated overheads that had accumulated over the past decade. But while he has reduced costs, Walsh has been less successful in disposing of unwanted assets. Attempts to sell an iron ore mine in Canada, a range of aluminum assets, and diamond mines in Canada, Zimbabwe and Australia have failed and the assets remain on the company's books as a drag on earnings. Iron dependency The underperformance of Rio Tinto's recently acquired assets has left it more dependent than ever on its core iron ore business, which makes up some 70% of the company's value. With production of 260m metric tons per year and rising, Rio Tinto is the largest single supplier of iron ore to the seaborne market, accounting for around 20% of the trade. That dependence means Rio Tinto has been brutally exposed to this year's collapse in iron ore prices, which have fallen more than 45% to their lowest level since early 2009. The slump has been propelled in large measure by the actions of the major producers, including Rio Tinto itself, which have flooded the market with low cost ore as a deliberate strategy to force higher cost competitors, particularly those in China, to shutter their operations. The big miners defend their strategy on the grounds that their costs are much lower than those of the smaller competitors they hope to drive out of business. However, Rio Tinto's approach of pursuing volume at the expense of price has carried a heavy cost for the miner. On one hand the 23% fall in Rio Tinto's share price this year (28% in US dollar terms) has opened the company up to criticism from Glencore and prompted institutional investors to question whether Walsh and his colleagues have any plans beyond their current policy of slashing costs. On the other hand the slide in Rio Tinto's shares to less than half the price paid by Chinalco seven years ago has exacerbated tensions with the company's Chinese shareholders, possibly leaving Beijing more receptive to a proposed breakup of the mining giant. Heightened tensions Chinalco's stake in Rio Tinto has long been a contentious issue within China's bureaucracy. Apart from the steady loss in value of their investment, two particular issues grate with the Chinese. Firstly, despite being Rio Tinto's largest shareholder they have never been invited to join the company's board, which many in Beijing regard as an anti-Chinese slight. The second matter that irks the Chinese is that in 2009 Rio Tinto abrogated a US$19.5bn deal that would have seen Chinalco double its stake in Rio Tinto and in the process gain two seats on the company's board as well as joint venture status in several key mines, including Rio Tinto's flagship iron ore mines in Western Australia. At the time Rio Tinto was struggling under a mountain of debt acquired as a result of its disastrous 2007 tilt at Alcan, and the Chinese saw themselves as the company's saviors. Chinese officials also have misgivings about Sam Walsh, Rio Tinto's CEO. They regard him as aloof, more at home in London than Beijing and less sympathetic to Chinese concerns than his predecessor Tom Albanese. Walsh also suffers in the eyes of Beijing because he was head of Rio Tinto's iron ore division at a time the Chinese naively believe they were exploited by a cartel of western producers which colluded to drive up the price of iron ore to the disadvantage of Chinese steel mills. That Rio Tinto's Chinese iron ore negotiator, Stern Hu, was sentenced to ten years in jail for bribery and theft of state secrets under Walsh's leadership of the ore business does nothing extra for the new CEO's reputation in Beijing. Troubled history While Chinese officials may not be fond of Walsh's Rio Tinto, they also harbor reservations about Glencore. These date back to 1997 when one of China's largest zinc producers lost US$130mn selling zinc short in a rising market. At the time officials blamed Glencore for encouraging naive managers to speculate beyond their means and capability, and warned other Chinese non-ferrous metal producers about the risks of dealing with the trading company. While the official attitude has softened over time, many senior executives in China's metals industry recall the incident and remain wary of doing business with Glencore. It is likely their doubts have been compounded by Glencore's trading culture, which seeks to maximize revenue. As the world's largest buyer of most minerals and metals, China naturally prefers Rio Tinto's production approach, which tends to maximize volume, leading to lower prices than the Glencore model. But although they have reservations about Glencore, both Chinalco and its political masters could look favorably on a renewed Glencore bid for Rio. Indeed, it is likely Glencore's Glasenberg has already smoothed the way. It was widely reported that Glasenberg spoke to Xiong Weiping, then Chinalco's President, before approaching Rio Tinto in October. It is not known what they discussed, but around the time of the reported meeting Chinalco established a committee of senior executives to examine the company's strategic options, which suggests that discussions may have included Chinalco's possible involvement in a Rio Tinto takeover. Deficient portfolio For Glencore, the advantages of a deal are clear. In recent years it has built an impressive range of commodity businesses through acquisition, and now bills itself as the only genuinely diversified natural resource company in terms of business activities, commodities and geography. Copper accounts for a little over 20% of Glencore's value, with energy?coal and oil?making up a similar proportion, while the company also has strong positions in zinc and nickel. However, the big gap in Glencore's portfolio is iron ore, a deficiency that explains the company's interest in Rio Tinto. Regulatory scrutiny Any tie-up between Glencore and Rio Tinto will certainly come under close scrutiny from regulators, especially those in China where the authorities have shown that they are more than willing to use their antimonopoly powers to benefit their national champions. Earlier this year Glencore was forced to sell the Las Bambas mine in Peru, one of the world's largest copper projects, to the Chinese-controlled and Hong Kong listed MMG for US$7 billion in order to secure the approval of China's Ministry of Commerce for Glencore's acquisition of Xstrata. Copper would again attract regulatory attention in any Glencore deal for Rio Tinto. Combined, the two companies would be the world's largest producer, commanding over 2mn tons per year of copper production?equivalent to 18% of global supply?and just pipping Chile's state-owned producer Codelco which has an annual production of just under 2mn tons. But whereas Codelco's production is confined to Chile, a combined Glencore-Rio Tinto would have greater geographic spread with mines in more than seven countries, including in Chile, where Rio Tinto holds a 30% stake in the Escondida mine, which at 1mn tons a year is the world's largest copper mine. Strategic priority Apart from the magnitude of the combined entity's current copper production, the regulators would also be concerned with the potential of several large development projects to expand each company's copper output. Rio Tinto has a 33.5% stake in Mongolia's Oyu Tolgoi, the world's largest copper project, which is slated to produce 450,000 tons of copper per year before the end of the decade. A large share in both the world's largest existing copper mine and its biggest copper development project is hardly likely to go unnoticed, especially in China where copper is near the top of the list of commodities nominated as a strategic priority. Regulators will also look closely at the combined companies' presence in the thermal coal market. With access to nearly 70mn tons per year of production in Australia, South Africa and Colombia, Glencore is the world's largest trader in the seaborne market. Regulators may well decide that the addition of Rio Tinto's 28mn tons of Australian production would put Glencore in an unacceptably dominant position, controlling over 10% of the world's seaborne trade in thermal coal. Divestments would be likely in the aluminum business too, where it is probable the combination of Glencore's trading volumes in primary aluminum?Glencore has an 8.75% stake in Russia's United Company RUSAL, the world's largest producer of aluminium, and markets 40% of its output?with Rio Tinto's production of 3.6mn tons per year would exceed regulators' tolerance levels. As a result, securing approval for a deal could take as long as a year, with the divestment of assets to appease regulators likely to be a complicated and protracted process, especially where Rio Tinto is locked into joint ventures which give its partners pre-emptive rights to acquire the company's interests should it withdraw from the project. Yet forced divestments are unlikely to faze Glencore's Glasenberg whose main objective remains the acquisition of Rio Tinto's vast and high quality Australian iron ore assets. Retaining as many of Rio Tinto's other operations as possible would be desirable, but Glasenberg is pragmatic enough to accept divestments as a small price to pay for ownership of the world's best iron ore assets. In any case, Glencore is likely to find willing buyers among China's state-owned companies. Chinalco, for example, may value a stake in Rio Tinto's low cost aluminum smelters, which benefit from supplies of cheap non-polluting hydropower. And as with any divestments, the proceeds would help fund the cash that Glencore would have to pay Rio Tinto's shareholders. Inefficiency and corruption Whether China's political masters will be quite as enthusiastic about picking up Rio Tinto's assets as the managers of their state-owned enterprises is less immediately obvious. China's state resource companies are plagued by inefficiency and tainted by corruption scandals. Chinalco's new head, Ge Honglin, was appointed last month with a brief to improve the company's disastrous bottom line?its listed subsidiary lost RMB4.12bn in the first half of the year?and has hinted that employee numbers will be heavily reduced. Meanwhile at least two of Chinalco's senior managers are being probed by the Central Commission for Discipline Inspection for "serious violations of discipline and law". Sun Zhaoxue was vice-chairman of Chalco, Chinalco's Hong Kong listed subsidiary and Li Dongguang was a vice-president responsible for Chalco's international trading unit. The detention of such senior executives may prompt the authorities to clip Chinalco's wings and concentrate major strategic decisions at a higher level. Moreover, several of China's recent high profile resource investments, such as Citic Pacific's stake in Australia's Sino Iron project, have proved to be financial disasters, prompting Beijing to be more judicious in their overseas acquisitions. However, this does not mean China has abandoned its long-held plan to acquire shareholdings in world class mineral assets. MMG's recent purchase of Las Bambas and Baosteel's acquisition of Australian iron ore hopeful Aquila Resources suggest the Chinese are pragmatic buyers who will make selective investments in commodities like copper and iron ore which they see as strategic resources. That pragmatism will be to the fore in any deal for Rio Tinto. As the world's largest consumer of iron ore, China deems the future of Rio Tinto to be of national importance. An approach to Chinalco by a potential suitor for Rio Tinto would certainly be reported to the National Development Reform Council, which would need to approve the involvement of a state entity, or the purchase of any assets divested by the miner's new owner. That approval may well be forthcoming. Xiao Yaqing, who as president of Chinalco first proposed a shareholding in Rio Tinto to the NDRC back in 2008, is now an influential deputy director at the State Council. It is highly likely that he would be keen for Chinalco to participate in any takeover of Rio Tinto as a vindication of his original strategy. Similarly, Chinalco's recently replaced President, Xiong Weiping, is now chairman of the board of supervisors at the State-owned Assets Supervision and Administration Commission. Although not as powerful as the NDRC, SASAC would also be consulted if any state enterprise were to participate in a takeover of Rio Tinto. Like his predecessor Xiao, it is probable Xiong would back the involvement of his former company. Such high-ranking Chinese support could prove invaluable to Glencore. Since the global financial crisis, western banks have been reluctant to lend to mining companies. And Glencore, with a relatively small market capitalization of US$58bn compared with Rio Tinto's US$78bn, and with a higher debt ratio, could struggle to fund a deal through conventional channels. However, if Glencore and Chinalco can agree on a takeover of Rio Tinto and a subsequent division of the spoils, Beijing may be prepared to support the transaction financially via China's state-owned banks. Calling the shots Securing a successful deal for Rio Tinto will still be difficult. But dealmaking is a skill that Glencore has in abundance. Even Glasenberg's critics acknowledge that he has yet to over-pay for any of his acquisitions. Furthermore, the cost savings achieved by Glencore following its 2013 acquisition of Xstrata demonstrate that Glasenberg's team is adept at stripping costs out of even the most tightly run operations. With the end of the commodity boom, international mining companies will need to adapt to a slower growth environment where capital is tighter, and where marketing skills which maximize revenue are more important than production skills that target maximum volume. This is an environment which is more familiar to Glencore than to Sam Walsh and his team at Rio Tinto, and it is an environment in which Beijing and its state-owned enterprises are increasingly calling the shots.

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