FINANCIAL REVIEW

SE Companies and Markets

HD **Ugly game of investment chicken**

BY Matthew Stevens
WC 1,214 words
PD 11 November 2014
SN The Australian Financial Review
SC AFNR
ED First
PG 32
LA English

LP

Matthew Stevens

The latest evidence suggests that when China Inc starts talking about dilution it doesn't muck around.

TD

Through a debt-to-equity deal with its majority Chinese owner, Yancoal Australia is asking its junior owners to pump $500 million into the hard-pressed coalminer or risk dilution of heroic proportions.

Yancoal is the product of a series of takeovers that culminated with the $2.1 billion takeover Gloucester Coal back in the days of peak coal in 2011. But what was built to be a showpiece of China's international coal aspirations now risks becoming a living, breathing case study in the risk investors take in being minority owners of a Chinese-controlled entity.

In effect, the owners of 22 per cent of Yancoal are being told to throw more capital into this severely challenged coal pot or to cede control of the business to Hong Kong-listed, mainland-controlled Yanzhou Coal Mining Company Limited.

The complicated arrangements were marketed on Monday by Yancoal and Yanzhou as a $US2.3 billion ($2.6 billion) raising through a renounceable subordinated note issue.

This looks like a refreshing vote of confidence in the Australian coal sector. But looks might be deceiving. The biggest chunk of this bounty looks to be little more than an accounting exercise, with Yanzhou acquiring $US1.8 billion of notes so that Yancoal can pay down an equivalent amount of borrowings from its Hong Kong-listed majority owner. Yanzhou cannot redeem the notes for five years. But they can convert them pretty much immediately. And the effect of that on non-participating minorities looms profound. Hong Kong's mini-Glencore, Noble Group, speaks for 13.4 per cent of Yancoal with a bunch of long-coal investors holding the balance of the minorities.

Each is said to be very unhappy at being drawn into this ugly game of investment chicken. They either stump up extra cash or they face being reduced to spectacular, almost laughable, irrelevance en route to compulsory acquisition at an very ugly discount to any past or present share prices.

The dark reality of the numbers is made all too clear in the Hong Kong filing by Yanzhou although not captured in the ASX announcement by Yancoal. Each $US100 capital note entitles the owner to 1000 Yancoal shares. Some 23 million notes could be issued, which means we are talking about up rights of up to 23 billion shares.

Just shy of 18 million of those notes will be acquired by Yanzhou. So it will be entitled to 18 billion in new shares when it chooses to convert. If, as seems quite likely, none of the other owners participate in this re-capitalisation, then Yanzhou will end up controlling 98.88 per cent of Yancoal. Given that incentive then, why wouldn't the junior owners participate in this raising? Well, outside of the obvious point that theirs would be the only new capital retained by the business rather than returned to the deal's sponsor, there is also some concern over cost of notes compared to the cost of the debt being paid down.

Yancoal says the initial 7 per cent coupon on the notes is "similar on average" to the debt being retired. The package of Yanzhou borrowings in question are due for repayment at various points between 2016 and 2020 and the longer debt, in particular, is said to carry interest rates that reflect Yancoal very certain non-investment grade status.

Nonetheless, there is a feeling Yancoal is embracing a higher cost funding option at the same time as it attempts to bully its minorities. Needless to say, this has only further strained an-already deeply fractured relationship between Yancoal and its biggest other owner, Noble. The mood has not been helped by the way this proposal was developed and disseminated. Quite properly, it was negotiated by Yancoal's four independent directors. But the need for discretion and independence didn't mean this should be done without the knowledge or endorsement of the Noble nominee to the board, Will Randall. But Noble people complain that is exactly what has happened.

The back story to this tension is as complicated as its latest expression. Noble was introduced as a minority in Yancoal with acceptance of the offer for Gloucester. It was a 68 per cent owner of the junior and the **stake** was always going to be traded to Noble's advantage. Noble is a commodities trader not a majority owner and operator, so it felt comfortable that less could bring more.

But what was planned to be a beautiful relationship turned sour midway through last year when Yanzhou made what Noble thought was a derisory bid to take full ownership of the Australian operation.

Noble resisted. And with no prospect of hitting the 90 per cent threshold for compulsory **acquisition**, Yanzhou eventually withdrew its offer.

Instead, it immediately loaned Yancoal a further $300 **million** to fulfil a commitment made to the Foreign Investment Review Board that it would protect the solvency of the business as long as it owned more than 51 per cent of the **company**.

That commitment still stands and Yanzhou and Yancoal say the proposed restructuring is the best way to deliver on that commitment. Arguably the most amazing aspect of this proposition is that it can be made without the need for a shareholder vote.

Yancoal insists a meeting is not required because this is a renouncement issue being made on equal terms to all shareholders. But it is also a deal that sees a related party fully exercise the leverage of the lending made to its listed subsidiary by manufacturing a transaction that would seem likely to see Yanzhou move to 100 per cent ownership.

Yancoal says the Foreign Investment Review Board has signed off on the deal. This should not surprise. Yancoal has been effective at convincing FIRB that what looks unpalatable actually tastes pretty good. Just last year FIRB relaxed the requirements that secured Yancoal's Gloucester takeover. It had been planned that Yancoal would release 30 per cent of its business to external investors and that it would unbundle ownership of a collection of **coal** mines by the end of 2013.

Instead Yanzhou got the nod to take full ownership of Yancoal. That invitation has clearly been repeated. That Noble is reviewing its options goes almost without saying. The more relevant question is what those options might be. The first step might be to make a call to ASIC. It has been delivered the latest version of the proposed prospectus but Yancoal people say "technically" ASIC's approval is not necessary to proceed.

Given Yancoal is right, the next best option for Noble and the other junior owners would be to head to the Takeovers Panel to test the waters on the standards required for the approval of what is patently a related party transaction. Finally, a lot of preparatory work on this proposal was done over months by Goldman Sachs. But Yancoal and Yanzhou chose to switch banks last week, delivering the mandate to Deutsche Bank. Whatever else that might mean, it is nice to see DB has found a **coal** business it can work with.

CO cenim : Gloucester Coal Ltd | yaptyl : Yancoal Australia Limited | ynzmn : Yanzhou Coal Mining Co Ltd | yankua : Yankuang (Group) Corp

IN i1 : Energy | i111 : Coal Mining | i112 : Coal Mining Support Activities | ibasicm : Basic Materials/Resources | imet : Mining/Quarrying

NS ccat : Corporate/Industrial News

RE china : China | austr : Australia | apacz : Asia Pacific | asiaz : Asia | ausnz : Australia/Oceania | bric : BRICS Countries | chinaz : Greater China | devgcoz : Emerging Market Countries | dvpcoz : Developing Economies | easiaz : Eastern Asia

PUB Fairfax Media Management Pty Limited

AN Document AFNR000020141110eabb00013

