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HD	**COLUMN-Risk-reward for Baosteel's Aquila bid looks skewed the wrong way: Russell**
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(The opinions expressed here are those of the author, a columnist for Reuters.)

By Clyde Russell

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LAUNCESTON, Australia, May 6 (Reuters) - Baosteel Resources' motivation for a hostile $1 **billion** takeover of Australia's Aquila Resources is to jumpstart a stalled **iron ore** project. The question is, why would the **Chinese** steel giant bother?

Baosteel is seeking to gain control of Aquila in order to get the junior **company**'s half-share of the $7 **billion** West Pilbara **Iron Ore** Project (WPIO), located in the north of Western Australia state.

At first glance the logic seems impeccable.

Baosteel, which already owns 20 percent of Aquila, was quite open with its frustration that WPIO had made little progress since the no. 2 **Chinese** steelmaker first invested in 2009.

Baosteel teamed up with Australian rail **company**Aurizon Holdings Ltd, announcing on Monday a A$3.40 a share offer for Aquila, which represented a 39 percent premium to the closing price on May 2.

Including Baosteel's existing **stake**, the offer values the target at A$1.42 **billion** ($1.32 **billion**). Aquila is sitting on A$507 **million** in cash and liquid investments, so the bid effectively values the debt-free **company** at A$913 **million**.

Baosteel is seeking at least 50 percent of Aquila, and this may be difficult to achieve given the 29 percent **stake** owned by Tony Poli, the target's executive chairman.

Poli has yet to comment on the takeover offer, but the assumption is that he won't be in favour of selling his **stake**, especially in light of Baosteel's decision to go hostile rather than try for an agreed **purchase**.

Nonetheless, even if Baosteel is successful in snaring Aquila, the question becomes whether another multi-**billion** dollar **iron ore** project in Western Australia makes sense.

The WPIO design calls for a 30-**million** tonne a year mine, a 420-kilometre (260 mile) rail line and a new deepwater port.

In other words, a massive investment in greenfield facilities in a country known for cost blowouts on major resource projects.

This raises the likelihood that the $7 **billion** budget is unrealistic, and therefore the cost per tonne will be more than expected.

Morgan Stanley estimated that the "stay-in-business" cost for WPIO is $75-$90 a tonne, which is below the current spot **iron ore** price <.IO62-CNI=SI> of $105.90, but also above the costs at larger mines operated by BHP Billiton and Rio Tinto.

The main issue is that if the WPIO project can be delivered by 2018, which would be an optimistic timeframe, what is the **iron ore** price likely to be by then.

IRON ORE OUTLOOK BEARISH

There is little doubt that the economics of iron ore are deteriorating, with additional supply likely to be substantially more than the additional demand generated by China.

China's iron ore imports were 820 million tonnes in 2013, a gain of 10 percent on the prior year. A similar gain is expected this year, with analysts polled by Reuters tipping imports of 910 million tonnes.

But it's increasingly unlikely that years of double-digit growth will last for much longer, as China's economic growth rate slows and the drivers shift from infrastructure and construction to consumer-led demand.

But even if iron ore imports do surprise on the upside, it won't be enough to absorb the extra supply coming on line in Australia and Brazil, with Citigroup and UBS seeing a surplus of 90 million tonnes this year, and Morgan Stanley forecasting an excess of 268 million tonnes by 2018.

So, why would Baosteel want to invest capital in a venture to add to an already oversupplied market, and at a higher cost than competitors?

The benefit of owning your own mine and transport infrastructure does give some supply certainty and may allow Baosteel to drive harder bargains when buying from other miners.

But spending billions of dollars to achieve this may not be the best use of capital, especially since it's hard to see iron ore prices rising in the next few years. If anything, they are more likely to fall below $100 a tonne than rise above $150.

Baosteel and Aurizon will also have to get the WPIO project off the ground with the cooperation of South Korea's POSCO , which bought a 24.5 percent indirect stake in the venture in 2010.

Baosteel need look no further than the experience of fellow Chinese companyCITIC Pacific, which suffered cost blowouts and delays and disagreements with partners at its $10 billion Sino Iron project, which started shipping last year.

No doubt Baosteel and Aurizon will be able to present a solid case for going ahead with the project, should their bid for Aquila succeed, but it seems the risks are all stacked to the downside.

($1 = 1.0787 Australian Dollars) (Editing by Richard Pullin)

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