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HD **Glencore puts Rio Tinto into focus**

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It is often a bad sign when a chief executive starts talking up the merits of a potential deal " particularly one that has been the subject of long-running discussions " in a very public way. So in early March, when Glencore chief executive Ivan Glasenberg gave a direct answer to a question about a NSW **coal** joint venture with Rio Tinto, it seemed an agreement was off the cards.

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"It's clear. Everyone knows it in the Hunter Valley. There's a lot of synergies between us and Rio Tinto in their Hunter Valley assets," Glasenberg said during a results briefing. "We've been talking to them for a long time. How far we'll get and how soon we can reach an agreement, I don't know. But it's something that clearly makes a lot of economic sense."

According to sources involved in the talks, it was indeed about this time that it became clear that a deal would not be struck. Contact between Rio and Glencore since then has been intermittent at best.

Nevertheless, the redoubtable Glasenberg is clearly not giving up on the idea. Last week, Glencore's first Australian site visit for analysts since the $US65 **billion** ($75 **billion**) merger with Xstrata was completed in May 2013 was used as an opportunity to raise the benefits of a Hunter Valley joint venture once again. The team at Barclays summed up the tone: "Management is clearly frustrated by the inability to conclude a pooling of their Hunter Valley **coal** assets into a JV with Rio."

THE NEW NORMAL

These are tough times for **coal** producers. Prices have halved over the past three years due to sluggish demand and chronic oversupply. Morgan Stanley forecasts the market for thermal **coal** used in power plants is expected to be in surplus by almost 15 **million** tonnes next year even though producers such as Glencore estimate about a third of seaborne trade is not making any money.

Under pressure from shareholders to act conservatively in the post-boom era, big miners are obliged to squeeze every last drop out of their assets. Strategies include asset sales, demergers and joint ventures. Against this backdrop, it is not hard to understand why Glencore is annoyed Rio is not more interested in pursuing a Hunter Valley deal that could generate annual savings of $500 **million** from sharing infrastructure, common procurement and headcount reduction, according to Credit Suisse.

It is unlikely Glencore's public utterances about the benefits of a JV will end the stalemate. Certainly not in the near future. "Deal making by megaphone," is how one source close to Rio put it. Nor is a mega-merger of Rio and Glencore of the sort described last month in a Bernstein research report going to happen unless something calamitous happens to the price of **iron ore**. But what the latest round of shadow boxing and speculation does tell us is how the companies are facing up to the "new normal" which will define the **mining** industry for the rest of the decade.

When Glencore and Rio began to discuss combining their **coal operations** in NSW in the first half of 2013, Rio was in a vulnerable position. The Anglo-Australian miner had in January sacked chief executive Tom Albanese after announcing a $US14 **billion** writedown of its failed takeovers of Mozambique **coal** producer Riversdale **Mining** and aluminium producer Alcan. Rio had written down the value of its aluminium division by more than $US29 billion since 2009. The board and new CEO Sam Walsh knew it could not afford any mistakes.

One of the first things Walsh made clear was that Rio was prepared to consider further asset sales to strengthen its balance sheet (more than $US17 billion of divestments have been undertaken since 2008). Glencore came knocking and Walsh appointed Deutsche Bank as an adviser. Many different options were explored but, as time went on, Rio felt its bargaining position grow stronger.

This is partly because Rio's net debt of $US16.1 billion at June 2014 (compared with $US22.1 billion a year earlier) was in line with management's target and partly because costs in NSW were now under control.

RBC Capital Markets claimed Rio Tinto Coal Australia's unit costs more than quadrupled to $US133 a tonne between 2005 and mid-2013. About a third of the increase was due to the strength of the Australian dollar. Under current energy boss Harry Kenyon-Slaney, costs are now 31 per cent lower (in US dollar terms) from the peak in 2010. -Further improvements are expected in the second half of this year. Glencore has also taken an axe to costs.

AUSTERITY MEASURES

Coal divisions have taken much of the pain as miners were forced to embrace austerity measures after the boom. The more productive Glencore and Rio's coal operations became, the less saving a JV would be able to generate. One of the key arguments from Glencore is that the location of Hunter valley mines for both companies are so close, it would be counter-productive not to explore sharing infrastructure. The slide pack for the site tour last week even includes a map of the combined operations.

But the map ignores other producers in the area such as Peabody Energy and BHP Billiton. It could be argued Rio (or Glencore for that matter) could explore common infrastructure with alternative partners.

Rio also believes, with some justification, its three open-cut NSW mines " Bengalla, Hunter Valley Operations and Mount Thorley Warkworth " are better quality than Glencoreoperations such as Ravensworth and Mount Owen. While Walsh has made it clear he is open to approaches, he also says it must be at a valuation Rio finds attractive.

For its part, Glencore, which is also a trader of commodities, argues it is bringing additional value to the table in the form of marketing expertise. For example, by blending coal for specific customers, it is able to charge more. It is also hopes an extension of Rio's Warkworth " which is in the middle of several Glencore mines " could draw Rio back into negotiations.

Perhaps. But it is unlikely to solve the kind of problems that arise when one party feels the other is trying to do a deal on the cheap.

Rio's energy division accounts for just 6 per cent of its net present value according to Deutsche. Iron ore is the main game, making up 64 per cent. With its balance sheet in good shape, the company does not need to rush into anything. If 2014 is about debt reduction, then next year is about giving cash back to shareholders. Even with the price of iron ore at current levels of around $US80 per tonne, Credit Suisse estimates Rio could make capital returns equivalent to 8 per cent of its market value.

A prolonged slump in the iron ore price is, of course, what Glencore needs to give it some leverage. Proponents of a Rio and Glencore merger such as Bernstein say it would create the world's largest diversified miner with a market-leading position in iron ore, copper, nickel, zinc and coal "as well as significant optionality around a number of lesser metals and minerals". It is a view most observers think Glasenberg shares.

But these arguments ignore the complexity of any deal (combining Glencore's -marketing and Xstrata's operations was hard enough), Rio's belief that it is finally performing in the interesting of shareholders, and regulatory backlash, mostly from China.

The Rio board no longer feels vulnerable. It would be highly unlikely to agree to any such deal, meaning Glencore would be forced to go hostile. You would never rule that out from an executive such as Glasenberg, but it would be a big ask.

Not that Rio should be feeling too smug. There is the issue of what HSBC describes as a company in a "strategic holding pattern". The analysts at Bernstein ask some good questions about the future direction of a company so reliant on one commodity.

"What is Rio Tinto's strategic identity in a world of slowing **iron ore** demand"? Bernstein asks. "We believe that Sam Walsh was given the mandate of righting the Rio ship post the **acquisition** of Alcan and Riversdale. Essentially the focus was on productivity improvement and the delivery of existing organic growth commitments.

"And Sam Walsh is to be applauded for having largely achieved this " question marks about the impact on the **iron ore** price notwithstanding. But what is Rio Tinto after this? What will be the strategic direction of Mr Walsh''s" successor"?

Hopefully in five years, Rio shareholders won't be asking why the **company** did not do more to chase growth outside **iron ore**.

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