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HD **Can Sino Iron Dig Out of Its Investment Hole?**

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Buying an iron ore mine in Australia has proven far more expensive than its Chinese investor imagined (Beijing) -- It looked like a profitable, no-brainer investment when China's CITIC Pacific bought an Australian iron ore mine for US$ 450 million.

The year was 2006, and soaring Chinese demand for the raw material needed to make steel and other iron products was pushing Australian ore prices to new heights. Imported ore prices shipped to China had hit US$ 60 a ton.

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CITIC PacificGroup then chairman, Larry Yung, charged forward, electing to acquire 25-year mining rights to 2 billion tons of magnetite – with an option for an additional 4 billion tons – at Cape Preston, Western Australia. A subsidiary CITIC Pacific Mining was formed to manage the project, called Sino Iron. Planned investment was more than US$ 3 billion.

What Yung didn't know was that the price tag on his decision would be far higher than expected and shake his Hong Kong-listed company to the core. The difficult experience has provided lessons for other Chinese companies to follow if they choose to invest overseas.

The project has endured years of delays and legal snags. Disputes between CITIC Pacific and the owner of the mine's mineral rights, Australian businessman Clive Palmer, are continuing in Australian courts. Nevertheless, processed magnetite ore from the strip mine in Western Australia is now being exported to China aboard ore carriers. The first ship loaded with Sino Iron ore powder sailed from the port of Cape Preston on December 2, bound for a CITIC Pacific steel mill in the eastern province of Jiangsu.

It's been a hard lesson. A source in Australia with government ties who asked not to be named said, "From Australia's point of view, we are very sorry that this project has become so difficult and the costs have been so high." Colin Barnett, the governor of Western Australia, said in recent years "Chinese companies swarmed" into his province in search of mining profits and "investing in some well-known iron ore projects. If there's a lesson, it's that they did too much too soon" without taking time to "find high-quality assets and partners." But at least some of the pain was self-inflicted, said Chang Zhenming, CITIC Group chairman.

"Sino Iron's difficult issues in the past happened because the company wasn't truly familiar with the local situation," Chang said. "This is 'tuition' Chinese companies are paying as they 'go out,'" which is another way of saying investing overseas.

Stumbling Blocks After landing in Australia, CITIC Pacific executives tried to make all the right moves. For example, they staffed the management team with local professionals in hopes of minimizing their "outsiders' disadvantage." The first executive chairman appointed to head Sino Iron and manage the mining project was Barry Fitzgerald, an Australian with more than 30 years of experience in the mining industry.

But Fitzgerald and other local staffers found it hard to work for CITIC Pacific. So in early of 2010, Fitzgerald resigned. He was replaced by Hua Dongyi, former head of CITIC's construction subsidiary in Africa.

Another staffing snafu that cost the Chinese dearly swirled around general hiring for the mine's construction and operations. The owners learned only after launching the project that Australian labor laws would not let them lean on imported, low-wage workers from China.

It was expected Chinese laborers would work at the mining site for state-owned engineering contractor Metallurgical Corp. of China (MCC), with which CITIC Pacific contracted to provide gritty jobs, such as digging the mine and building processing facilities.

Under the January 2007 contract, MCC agreed to install crushing and pellet plants, procure mining equipment and build a camp for mine laborers. The mine was supposed to be up and running within three years.

But Australia's labor regulations stood in the way of the plan to import labor, slowing the project. One rule says a foreign worker must speak English, and earn at least a grade six on the International English Language Testing System. Moreover, all foreign electricians, welders and other tradesmen have to pass Australian-standard professional exams before they can work in the country.

Australian law also says the same wage rates apply to foreign and domestic workers, blowing away MCC's plan to pay mainland China rates and house imported workers in low-cost camps.

Labor costs thus mushroomed far beyond expectations, as MCC and CITIC Pacific were forced to staff their operations with Australians. At the construction period peak, only about 400 of the site's 4,000 workers were Chinese.

Worker housing costs also ballooned dramatically to US$ 300 million, from a MCC's initial quote of US$ 30,000, said CITIC Pacific President Zhang Jijing.

In the project's early years, cost overruns and CITIC Pacific's decision to double the mine's lifetime output to 2 billion tons from 1 billion tons of ore hiked the project cost to US$ 1.75 billion from an initial estimate of US$ 1.11 billion. Moreover, production capacity was increased to 24 million tons from 12 million tons of ore per year.

Higher and Higher Sino Iron was supposed to start delivering processed ore in early 2009. But the changes and extra costs contributed to a nearly five-year delay, which ended when an ore carrier with the first shipment set sail for China in December. During those years, MCC's charges climbed to dizzying heights.

Under a contract amendment signed in mid-2010, CITIC Pacific agreed to pay another US$ 835 million to MCC to compensate for higher-than-expected labor costs. By the end of 2011, the total price tag was again increased to US$ 3.3 billion.

At a meeting where CITIC Pacific announced its 2011 interim results, company executives said they had been disappointed by MCC's overruns. But the contractor's executives replied that they had not expected to encounter so many hurdles at the Sino Iron project.

MCC then raised its bill 30 percent, to US$ 4.3 billion, prompting CITIC Pacific to agree to pay another US$ 822 million at the end of 2012.

CITIC Pacific tried to save money by taking over all project procurement. It also started working with MCC to jointly manage project testing and safety operations. At the same time, it cut MCC's contract scope to two production lines from six.

More negotiations ensued, and in January 2013 CITIC Pacific agreed again to raise the contract fee, this time to US$ 4.36 billion. MCC, however, wasn't satisfied and demanded US$ 4.9 billion. The two sides were still negotiating as of early January.

And the MCC bill is just part of the total Sino Iron project cost, which investment analysts say had reached US$ 9.1 billion at the end of 2012, including $ 6.8 billion in construction costs. A Goldman Sachs report estimated total investment will reach US$ 11 billion – more than three times CITIC Pacific's original plan.

Chang, who was appointed chairman in 2009, said that appreciation of the Australian dollar contributed to the higher price tag. But what really pushed costs higher, he said, were the unexpected costs of doing business. Indeed, CITIC Pacific had never mined iron ore before diving into the investment.

"We didn't understand actually how to develop a large-scale mine in Australia," Chang said. "We assumed we could apply a template of the domestic experience, and we seriously underestimated the construction project's difficulty." MCC officials offer a long list of reasons for the delays and cost overruns: a lack of project preparation that led to a construction start without sufficiently understanding Australian laws;

project management and implementation costs; slow construction preparation work by the owner of the mine site; changes in the design plan and equipment selections; automation that required costly testing and debugging; several hurricanes at the project site; shipping delays for inbound materials; and a lack of experience in handling large overseas projects.

The project also paralleled a boom for mine expansions across Australia that affected costs. In 2010, for example, demand for mining truck tires was so strong that they had to be ordered up to three years in advance.

The project also required construction of a power plant, slurry pipelines, desalination plants and a port for **China**-bound ore carriers. Ore extracted from the site has a low magnetite content, which means before going to market it has to be ground to a **milk**-powder consistency.

CITIC Pacific's steel plant in Jiangsu took the first load of this powdery ore, which came off the mine's first production line. A second ore production line was undergoing testing and four more were under construction as of early January.

Investment analysts have offered mixed forecasts for the project. A Citibank report is upbeat, saying Sino Iron will ensure a steady, long-term supply of high-quality ore to **Chinese** steelmakers. But Goldman Sachs has reservations about the project's value, noting that ore prices have been falling even while Sino Iron's costs have skyrocketed.

Prices actually climbed in 2013 to an average US$ 135 per ton for iron ore. But industry insiders say that price level will be hard to sustain.

On the supply side, 100 **million** tons of new production capacity worldwide should come online in 2014. Yet the **Chinese** government's efforts to fight air pollution and steelmaker overcapacity will affect ore demand.

And if ore prices fall, a banking source said, companies that built ore mines such as Sino Iron may struggle to repay loans.

Sino Iron represents one-third of CITIC Pacific's assets. Other businesses are in steelmaking and real estate. Thus, **company** management has long considered the Australian project as a primary task.

Now that Sino Iron's construction phase is winding down and ore shipments are under way, CITIC Pacific's focus will turn to making the project pay off for the **company** and its investors. Whether that happens remains to be seen.2

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