HD Factors for Successful Chinese Investment in the Australian Mining Industry: A Case Study of Baosteel Consortium's Acquisition of Aquila

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Since the global financial crisis in 2008, China has seen explosive growth in overseas investment. The Ministry of Commerce forecasts that the size of China's outbound direct investment will exceed that of foreign capital utilization for the first time in 2015.1 Australia is one of the earliest countries which Chinese companies have gone out for, and is the second largest target for China's overseas investment, second only to the United States. Mining is undoubtedly the industry that has attracted most investment from China into Australia. Although there has been a decline in China's investment into the Australian mining industry in recent years due to factors such as the falling market demand, carbon tax policy, the emergence of alternative countries with resources, the investment in the mining industry in Australia continues to account for the majority of the total investment value.

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Over the past few years, we have seen great media coverage on failed mining investments by many Chinese investors. Over the past few years, we have observed that some Chinese investors have progressively accumulated experience and gained experiences and skills to conduct complex cross-border transactions in mature markets such as Australia. As a result, we have seen more and more successful deals. In this article, we will discuss those factors key for successful merger and acquisition (M&A) deals in Australia's resources section through a case study on the recent high-profile deal-aosteel Consortium's acquisition of an ASX (Australian Securities Exchange)-listed iron ore miner.

Transaction Overview2

Aquila Resources Limited ("Aquila") is a company listed on the ASX, whose main assets are the West Pilbara iron ore mine and Eagle Downs hard coking coal project. Except for a few coal mines which are in operation, the remaining assets of Aquila have not yet entered the exploitation stage.

On 5 May 2014, the consortium ("Baosteel Consortium") consisting of Baosteel Resources Australia Pty Ltd. ("Baosteel") and Aurizon Operations Limited ("Aurizon"), an Australian company, initiated the takeover bid offering to acquire all issued shares of Aquila at the price of AUD3.4 per share and a total price of about AUD1.4 billion.

This is a hostile takeover - Baosteel Consortium made the offer directly to Aquila's shareholders, bypassing the board. The main conditions for the offer include: the minimum percentage of shares to be acquired, i.e., 50% of the ordinary shares in Aquila, and receipt of the No Objection Letter granted by Australia's Foreign Investment Review Board (FIRB) for Baosteel and Aurizon's acquisition under the offer. The parties then obtained FIRB's No Objection Letter on 29 May.

On 12 June 2014, Mineral Resources, an Australian company, confirmed its intention to initiate a rival bid against Baosteel Consortium, and purchased on the market 12.78% of the ordinary shares in Aquila at a higher price. However, on the next day, the Baosteel Consortium made the statement that they were unwilling to raise the offer price. Then shortly after that, Mineral Resources dropped its bid. On 20 June, the board of Aquila released the Target's Statement, recommending shareholders to accept Baosteel Consortium's offer.

On 4 July 2014, the Baosteel Consortium announced to the market that all conditions for the offer had been satisfied. As of July 25 when the offer was expired, the Baosteel Consortium had obtained a total of 98.49% of the ordinary shares in Aquila, and would acquire the outstanding shares through the compulsory acquisition procedure. Until then, the Baosteel Consortium successfully completed their takeover of Aquila in less than three months.

Success Factor 1: Familiarity with Target Assets

This transaction, featuring junior mining projects and large-scale acquisition, reminds people of CITIC Pacific's Sino-Australia Magnetite Project. In 2006, CITIC Pacific obtained the right to develop the Sino-Australian Magnetite Project by acquiring the Australian company Mineralogy. Since CITIC Pacific and its Chinese EPC contractor significantly underestimated the development costs for the project, it turned out that the actual development costs was several times higher than the budget. CITIC Pacific consequently suffered substantial losses. It is believed that CITIC Pacific's lack of knowledge of the target assets and the local investment environment is the main reason for its failure.3

But Baosteel Consortium's transaction is different from the CITIC Pacific's one. Baosteel has had a good knowledge of the target assets before the takeover. Back in 2009 Baosteel has made strategic investment into Aquila by acquiring 19.78% of the issued shares in Aquila, and by doing so, it also obtained a seat on the board of Aquila. Therefore, over the past five years, Baosteel has been able to look closely at Aquila's operation and the development of the West Pilbara iron ore project. In addition, sources say Baosteel had conducted secret negotiations with Aquila on the development of the project before the takeover.

Being familiar with the target assets should also be a key condition for Baosteel Consortium to take the initiative to do a hostile takeover, and by doing so, accelerate the transaction process. Usually, when making acquisitions, the buyers who know little about the target assets must solve the problem of "asymmetric information" through due diligence. Although the due diligence on a listed company can be conducted, to a large extent, through reviewing the disclosed information, the disclosed information is subject to limitations such as the scope of and delays in making disclosures. If the buyer wants to get more information, it has to rely on the cooperation of the board of the listed company. In the event of a hostile takeover, because the buyer will not have the board's cooperation, it cannot conduct adequate due diligence. Therefore, it has to put in a long list of conditions in the offer to protect itself. All these factors, coupled with the fact that in the event of hostile takeover, the buyer will not have the protections such as the break fee cause hostile takeovers to be very difficult to carry out.

Therefore, Chinese investors are generally reluctant to do hostile takeovers. In the event that they are forced to do so, it is very difficult for them to make success. For example, Cathay Fortune Corp. (CFC) initiated a hostile takeover to acquire Discovery Metals Ltd. It carried out the due diligence relying mostly on the information disclosed by the target company. But later, CFC found that the target company made false disclosure on its copper reserves. As a result, it decided to let the offer expire by not extending the offer period, and dropped the bid on the ground that some of the conditions for the offer were not satisfied by the expiration of the offer period.

The Baosteel Consortium does not have the problem of "asymmetric information", and therefore is not hindered by this problem from doing hostile takeover. In fact, the Baosteel Consortium gave little time for the board of Aquila to consider its offer before made the offer directly to the shareholders, thus effectively avoiding the adoption of delaying tactics by the board of Aquila and closing the transaction in a short time.

Success Factor 2: Seizing the Right Time to Enter into the Transction and Following the Market Trend Closely

At the time when the Baosteel Consortium launched the takeover, the global iron ore market was sluggish, and valuations of the mining companies are low. It was particularly true for junior mining companies like Aquila. Aquila needs substantial funding to develop the greenfield projects. However, as prospects of the financial market are not optimistic, it is difficult for Aquila to find a stable source of financing. Just before the takeover, Aquila was facing significant operational risks, and its value-at-risk in the market was about AUD1.05 billion. In comparison, the offer made by the Baosteel Consortium provided a premium of about 40% of the value-at-risk.4

This is obviously an attractive offer. In this context, although the board of Aquila noted in the Target's Statement that the offer did not fully and fairly reflect the potential value of the company and its Pilbara iron ore assets, it recognised that it is a reasonable offer.5

The Baosteel Consortium's takeover of Aquila amid market fall is very much "buying straw hats in winter". But long-term strategic investors like Baosteel have good reasons to do so. It is easier to make the offer attractive when the market is down. Also, the acquisition costs are significant lower compared to Baosteel's acquisition of Aquila shares in 2009 when it offered the price of AUD6.5 per share.

Baosteel should have made the deal based on the lessons learnt from the previous failures suffered by other companies. Previously, a number of Chinese companies' mining investments in the Australian were successful if judged purely from the perspective of transaction techniques. But as they choose to enter the market at its peak, then when the market went down after their investments, they inevitably suffer losses. For example, in the aforementioned CITIC Pacific's case, at the time of the investment, the iron ore demand was high in the global market and its price was in the uptrend. CITIC Pacific made the investment based on the assumption that the iron ore price would be on the rise in the coming years, and it would in turn definitely make profits after the project reached the production stage. However, the iron ore price had turned to a downtrend since 2012, resulting in the development costs of the project higher than the market price. CITIC Pacific thus got stuck in a dilemma. Yanzhou Coal Mining Company Limited (YCM), who was widely believed to have made successful investments in the Australian mining industry, also suffered the losses from asset impairment in 2013. Analysts believe that the losses were suffered because in 2011 when YCM acquired Felix, the coal price was high, but since 2012, the coal market has worsened, which caused many problems for coal enterprises such as difficulties in sales, significant increase in financial expenses, great pressures in loan repayment, difficulties in financing, and extremely tight cash flows.

Success Factor 3: Transaction Techniques

Choosing local partners

In the past, Chinese investors usually cooperated with Chinese EPC contractors for projects involving infrastructure constructions. But in Baosteel's transaction, for the first time, it chose Aurizon, a local company, as the EPC contractor, and partnered with Aurizon as co-bidder to jointly carry out the investment. This proved to be a wise choice.

To start with, Aurizon, as an Australian local EPC contractor, has rich experience in developing similar infrastructure projects. With Aurizon as the partner, Baosteel can avoid the difficulties and risks arising from the lack of knowledge of the local market.

Further, as partners, the parties can have win-win cooperation in achieving their respective commercial goals: Baosteel desires to acquire the resources and act as a long-term strategic investor, while Aurizon wants to obtain the exclusive right to develop the infrastructures including the West Pilbara railway and port, and will seek exit after the completion of the infrastructure development. This sets the basis for their cooperation.

Further, Aurizon is more experienced in similar transactions, and Baosteel can depend, to a large extent, on Aurizon for carrying out the takeover.

Last but not least, Aurizon's involvement made it easier to obtain the necessary approvals (see below for the detailed analysis).

Approvals

In Australian, takeovers of resource companies with large-scale assets by foreign investors like this transaction are considered as sensitive transactions. Therefore, it is not uncommon for foreign investors to have difficulties in obtaining FIRB's approvals. For the previous deals such as Yancoal's acquisition of Felix, the investment of Wuhan Iron and Steel (Group) Corp. in Western Plains, and the acquisition of Lynas by China Nonferrous Metal Mining (Group) Co., Ltd., the acquirers had encountered difficulties in obtaining the FIRB's approvals. When Baosteel made on its own the acquisition of no more than 19.9% shares of Aquila in 2009, it made two submissions before obtaining the FIRB's approval.

This acquisition was granted with FIRB's approval very quickly. This may be attributed to the fact that Baosteel partnered with Aurizon, a company with good reputation in the Australian market, which made the deal more acceptable.

Also, with Aurizon as a co-bidder, Baosteel lowered its investment amount to below USD1 billion so that it avoided to go through the verification process with the National Development and Reform Commission. This not only saved the transaction time, but also excluded the necessity of setting the Chinese regulatory approvals for overseas investments as a condition of the offer, which added to the certainties of the offer.

Right strategy against "spoiler"

In previous similar deals, Chinese companies often took the tactics of raising the purchase price when there were other bidders. For example, in the acquisition of OZ Minerals by China Minmetals Corporation (CMC), to thwart the rival proposal put forward by certain investment banks, CMC raised the purchase price by 15% at the last minute before the general shareholders meeting of OZ Minerals was held. As another example, Sinosteel Corporation also adopted the same strategy of raising price in its acquisition of Midwest when encountered with rival bidders.

In this transition, when Mineral Resources acquired the shares at a higher price to force the Baosteel Consortium to raise the purchase price, the latter immediately confirmed its unwillingness to raise the price, and at the same time conveyed the following message to the market: only the Baosteel Consortium was capable of making the takeover of Aquila, and if the takeover bid fell through, Baosteel would seek exit from Aquila. As Mineral Resources was in no way able to make the takeover of Aquila, it had no choice but to drop its bid. It goes without saying that, the Baosteel Consortium's success in the takeover lines not just in its calm assessment of the market situations but also thanks to the fact that the market situation is more favorable to the Baosteel Consortium at the first place. The same strategy may not work if Baosteel had chosen to make the takeover at the peak of the market.

Conclusions

Australia attracts **Chinese** investors with its abundant resources, high degree of rule of law, and advanced technologies. As a mature and sophisticated market, it also has very high standards on the experience and capabilities of the investors. It is necessary for **Chinese** investors to draw experience and lessons from past successful and unsuccessful deals. Transaction techniques such as undertaking proper and adequate due diligence, teaming up with good local partners, investing through consortium, and structuring deals to simplify regulatory approval procedures are all important. Further, to progressively get to know the target assets through small-scale investments and to wait for the right timing to execute the transactions also proves to be critical.

Footnotes

1http://finance.sina.com.cn/**china**/20140916/201920309217.shtml, "Ministry of Commerce: the size of overseas investment may exceed that of foreign capital utilization in 2015? (last visit was on October 31, 2014).

2 This part was sorted out based on the relevant announcements disclosed on the website of the Australian Securities Exchange (http://www.asx.com.au/) by Aquila.

3 This event was widely reported in the media. Reports included "CITIC Pacific's **iron ore** mine was put into production eventually, and the EPC contract with MCC may be suspended" (http://money.163.com/12/1121/07/8GQOI659002529T0.html) (last visit was on October 31, 2014).

4 http://finance.sina.com.cn/chanjing/gsnews/20140506/001219007173.shtml, "Analysis of Baosteel's intention to acquire Aquila: to build a resource base in West Pilbara" (last visit was on October 31, 2014)

5 For details, please refer to the Statement of the Bidder disclosed on the website of the Australian Securities Exchange (http://www.asx.com.au/) by Aquila.

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