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Hallgarten & Company

Portfolio Strategy

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Rio Tinto & Chinalco

Check …. and Checkmate

Rio Tinto/Chinalco

The window of opportunity slams shut for big buys

- + The withdrawal of Rio Tinto from its previous arrangements with Chinalco is an important development which ultimately is good for shareholders in Rio Tinto, good for mining investors in general and good for Australia
- + The Chinese manipulation of the copper market has backfired badly, effectively providing the economic basis for a recovery at Rio Tinto which now ultimately has overturned the Chinalco deal
- + Various resource provinces are now off the radar for the Chinese, except for second and third tier assets
- + Latin America, Africa and South East Asia are the only hunting grounds open to Chinese attentions. Even some of these may produce a backlash eventually
- + Attempts to corner base metals markets have failed miserably yet again
- + Base metals could stay around their current levels as destocking has left manufacturers with low inventories and massive capacity shutdowns in zinc and nickel (and to a lesser extent copper) have reinforced the perception that the longer term supply deficit in most metals has not gone away and has probably been exacerbated.
- ✘ The Chinese dabbling in the markets may retreat in the short-term (and they may even attack prices to create a bear-trap for speculators that followed them in)
- ✘ The blocking of Chinese advances means that a significant player in M&A has been removed from the scene for “onshore” assets in those markets that are now outside the pale for Chinese.

Stymied at every turn

We cannot help but be amused at the latest Chinese mining dilemma. There….we said it… most others have been pussyfooting around but frankly few are prepared to admit their *schadenfreude* at the mess the Chinese have got themselves into. In preparing our bullet points at the start of this note it is usually clear what is a positive and what is a negative. In the current environment what we see as a positive for us, the mining community and investors is most likely a negative for the Chinese “grand strategy”.

But surely the Chinese have been playing by the rules? No hostile bids.. everything arranged sweetly with the managements… so why has this latest deal come to grief and why does it signal an even bigger problem going forward for the Chinese?

Why are the Chinese being thwarted while the Indian group, Vedanta, have been able to squirrel away assets all across the globe (including almost getting their hands on the carcass of Asarco)? Maybe it is that the Indians are not suffering from a bout of hubris. The Chinese though were not boasting of how much money they had, so why should they be so disliked and despised? Fear…and overweaning ambition would seem to be the reasons.

The same type of attitude that turned Russian billionaire oligarchs into a subject of derision has now turned against the Chinese. The attitude of “I want it and I want it now” is anything but inscrutable and it has got up the backs of opponents. The Japanese built their economic miracle upon a symbiotic relationship with iron ore producers, and coal miners around the globe. The Chinese, in contrast, rampaged through the iron ore market bidding up prices for a fistful of years and then complained when prices got too high. Their solution to this was to decide to acquire the companies that were “holding them hostage”. They got away with this for a little while in Australia, with a number of plum assets falling into their hands, but now the worm has turned.

It is curious that it has been the private sector saying “no” to the Chinese while PTBs in the targeted countries have remained largely quiescent. Or are they? Australia, in particular, has felt a need to walk a tightrope where a rising domestic tide of opposition to Chinese buying of mining assets ran counter to a generally warm and fuzzy approach in public interchanges with the Chinese. Much mileage was made at the time of the last Federal elections of the fact that the Labour Prime Minister Kevin Rudd could speak Mandarin. This has now backfired with claims of appeasement leaving him vulnerable to public displeasure and with little room to move except by resorting to feeble strategic arguments such as the ruling that OZ Minerals Prominent Hill mine was too close to a military installation. The failure of the Chinalco deal with Rio Tinto has meant the government has dodged a bullet that was heading its way and to which it had inadequate responses to hand. “Just say No” was not in the political armoury.

Another Close Call

In March 2009 we wrote a report on the Minmetals bid for OZ Minerals. The day after we published the Chinese had to revise their offer in light of “security objections” from the Australian government. In recent weeks talk has rattled around the market of a competing bid appearing with RBC as a promoter of the alternative offer. There was also a refinancing bid floating around with the backing of Macquarie Bank. This week the Minmetals offer was hiked by 15% last night to $A1.7 billion ($US1.39 B), on the eve of the shareholder vote, to stave off this threat.

Interestingly the RBC counteroffer was reputedly going to be made at the former level that Minmetals was offering. We have no doubt that the shareholders would have chosen the competing offer, even at the same price, over what Minmetals was offering. Possibly the RBC push was only a gambit to get the Chinese to hike their price but the rising price of zinc, copper and gold gave sound justification to those who felt the Chinese offer was too low. Curiously the OZ Minerals buy brings two Canadian zinc projects into Chinese hands.

The Chinese had better savour the OZ Minerals success because we feel it may be their last in this size category.

What this means…

Those who would gloss over the latest setback and describe it as merely a “setback” are failing to understand the real reasons behind the “debacle” (as we prefer to term it). This is a seminal moment. It essentially means that the most advantageous slump in metals prices and corporate valuations in the last ten years has passed by and the Chinese have managed to glean virtually zero benefit from the whole process. Moreover, the moment provided the chance to get assets, not only cheaply, but at a time when nationalist considerations in the target countries were at their most vulnerable. Not that the nationalist proponents didn’t want to say something about Chinese ownership of strategic assets, but they were largely disarmed by closures and bankruptcies with essentially “no-one else” interested. A case in point being the demise of OZ Minerals.

However, now that moment has past. And even some of the transactions done at the darkest hour are coming unraveled. Rio Tinto is the prime example but we might also point to the supposed counter-bidder lurking in the wings to upset the OZ Minerals deal that Minmetals thought it had in the bag.

The way things have played out is that a new age has dawned and times are tough for the Chinese. In essence some assets “can’t be had for love nor money”. Some countries have closed down or slammed the door. This is not a stated policy but it is pretty clear. The Chinese have moved and shaken behind closed doors and not achieved very much. The places where they haven't been able to achieve deals when it was pretty obvious that deals were going begging gives the game away.

The no-go areas for the Chinese are:

- Russia (would be enormously surprised to see any Chinese investment allowed in this sphere)
- Canada (only second tier acquisitions will be allowed and only then in metals where there is an unseemly abundance)
- Brazil (unlikely to be allowed access to any iron ore… besides that only second tier resources might be allowed to fall into Chinese hands)
- Australia (unlikely to be allowed any more Tier One assets in any metal… unlikely to be allowed any more position in iron ore)
- Indonesia (Chinese might have a pass for the very short term but could eventually be thwarted by anti-Chinese sentiment in a country with long-standing tensions between the native population and ethnic Chinese merchants)

This leaves the Chinese with a few key playgrounds. These are:

- Africa
- Latin America
- South East Asia

The former has been tackled thus far largely via direct investment and some infrastructure horsetrading with the governments in places like the DR of Congo. The most prospective places for the Chinese are the base metal focused locations such as DRC and Zambia with a traditional coziness with Tanzania. There is some scope in West Africa but the main metals in that zone are precious (with bauxite already strongly under the control of multinational aluminium majors). Some governments must be wary of the Chinese influence where fickle support might include support for ousters if the incoming power group better suits Chinese interests. The next step might be moves upon listed companies in London or Toronto with activities in the most interesting metals in the most pliable countries. The British government wont ride to the rescue to block deals and the Canadian government would be on dodgy ground if it tried to oppose takeovers in the national interest when all the assets are in some exotic location.

The last point holds true for Latin America as well. Northern Peru Copper, Tyler Resources and Peru Copper all succumbed to Chinese offers in recent years as they "fell between the cracks" and critics couldn't muster a credible argument to resist when the assets were away from the Canadian motherland. This means that a whole swathe of corporates are now potentially fodder for the Chinese and they had better move swiftly to secure them before some new excuse can be mustered to block their progress. Thus a gaggle of copper miners along the Andes are sitting ducks for bids. Added to this there is potential for offers for moly assets in Mexico and zinc and lead assets in Peru and Mexico. Specialty metals like antimony and tungsten also hold allure for the Chinese.

South East Asia is an area not talked about much in North American mining circles as most of the players in the space are Australian listed. We noted though the recent strategic stake sale in Pan Australian Resources (a company focused on production in Laos and Thailand) as a forerunner of the Chinese snapping up assets in its "own backyard". The OZ deal brought the Sepon mine in Laos under Chinese ownership.

Tit for tat

We might note briefly that the Chinese have not been able to get on any soapbox through the various tribulations they have "suffered" because they have been one of the guiltiest parties in recent years in pursuing resource nationalism in the base metals space. China is essentially a "no-go" area for anything except gold at the current time. The Canadian government in particular knows what its miners have suffered in China (finding assets only to have them confiscated a la Georgia Ventures) and thus the Chinese don't even bother to go for Canadian onshore mining assets any more (except the most insignificant).

We will no longer take any meetings with companies that profess to have assets in China as it is a waste of time.

Hoist on their own petard?

Lets make it simple. Markets are depressed. You plow into the market buying lots of inventory when you don't really need it. Prices rise. The prices of the mining stocks rise. Distressed miners are no longer distressed. They no longer need the desperation capital injections they previously agreed to. Sound familiar?

Once a market manipulator, always a market manipulator. So does this sound like an own-goal or what? Both the Rio Tinto deal flop and the threat of the OZ Minerals deal falling apart can be slated home to Chinese fooling (and the word "fool" is chosen carefully) around in the metals markets. Finally the blood rush to the head has been their undoing. This, and only this, is good enough reason to celebrate the failure of the Rio Tinto transaction. This is exactly the reason why Australian politicians had started to feel the Rio deal sticking in their craw. Tim Geithner may not be able to force the words from his lips but the Chinese are manipulators of commodity prices (and currencies). The US government may be over a barrel and thus loathe to admit the fact but many in the mining community whisper *sotto voce* amongst themselves about the latest moves in the commodity prices and who is moving the prices and why they are doing it. The culprit is usually the same party (and has been since 2003) in most metals. However giving credit where credit is due, Goldilocks and the PTBs (rather than the Chinese) are usually the guilty party pushing the price of oil and gold around to further their own ends.

Not only have the Chinese pushed prices around to the detriment of all, they get all petulant when they do not get their way. Was it any coincidence that after weeks of pushing the envelope in the copper market, the selfsame week that the wheels fall off the Rio deal, the copper stocks at the warehouse of the Shanghai Metals Exchange jump 51% in a week? This should have been reason enough to send copper into a tailspin (maybe this is what they hoped) but unfortunately many months of steady buying by the Chinese had drawn in other buyers, created the impression of revived demand and the end of the recession being within sight. Thus the "warehouse dump" (a classic Chinese move that Bruce Lee would have embraced if only he had been a commodities trader) is now like water off a duck's back to the copper market. The Chinese may be famous as gamblers but their abilities at bluffing it in the metals markets now have almost negligible effect.

Not all metal demand is created equal

It might be useful to review the metals and comment on the nature of Chinese interest and their potential for success in securing supplies:

Gold: there has been zero interest from China in securing access to this metal, thus far. As the world's largest producer it has no shortage of its own supply. Neither is it a metal that is "used up" in the industrial process. In any case it is also probably the metal that the Chinese public are stashing away so instead of buying mines the Chinese government is just leaving it to the man in the street to stash away his own share of the global output. We might note, as we did at the mining roundtable in NY last week, that if (when?) the PTBs in China express an interest in buying gold mining assets offshore then that will be the clearest sign possible that the Chinese have fallen out of love with the US dollar and want to "get the hell out of Dodge".

Silver: zero interest… to the chagrin of the silver bulls.

Zinc: this is the metal where the Chinese have had the most ostensible success. The assets they have snaffled include Perilya Mines, Terramin and Oz Minerals in Australia. Curiously they probably could have snapped up Lundin Mining in early 2009 as the Hudbay deal fell apart but stood back from the fray. The company is still 75% off its 2006 highs and might be detachable from the Lundin family's grasp in light of their current enthusiasm for gold.

Lead: hard to buy on its own. The pursuit of this metal might be the only reason the Chinese might express an interest in silver producing assets. Some of the zinc mines being pursued in Australia bring this along as a credit.

PGMs: who needs catalytic converters.. they are for wimps

Tin: the Chinese are swimming in this metal. While Australia is a major producer it is probably easier to hunt for this in South East Asia. However, wouldn't it be tragic if the Indonesians suddenly turned their dislike for the Chinese corner shop owner into a broader dislike for Chinese policy in the region?

Uranium: Central Asian states might be a playground and possible Latin America (Argentina being highly prospective) and there is always West Africa, but behind closed doors there may be US leaning on governments in these places (or revival of the US stockpiling policy) to block Chinese buying. Brazil has a ban already on non-Brazilian companies exploiting this "metal" and we would see Chinese buying being banned (either tacitly or explicitly) in Australia and North America. This is one "metal" where they may be forced to use their own supplies.

Copper: As previously mentioned the Chinese are likely to have to focus on Africa and LatAm for this resource. Expect more buys like the Peruvian purchases of 2007, but this time up and down the Andes into Ecuador and Chile. These will be mainly largish second tier assets rather than first level mines. The assets are largely in Canadian hands but arguments against Chinese bids will be feeble. Any riding roughshod over local sensibilities in LatAm would be a BIG mistake. This is not Africa where you can bring in some PRA goons to "neutralise" local opposition.

Cobalt: These assets are in Africa largely and come as a package deal with copper. We know of one sizeable asset in Mexico though (Baja Mining – BAJ.to) but it is already in the Korean camp. Cobalt is the asset that we were approached to find for the Chinese at the end of 2008 in a "must be top four in world deposit" declaration. This caused us to guffaw as "top four deposits" are all locked up in the hands of the majors and the Chinese should know it. Then again maybe not knowing what is real and what isn't is what has got Chinalco into its current mess.

Iron ore: oops.. blocked on all fronts. Vedanta has El Mutun in Bolivia. As we noted it is unlikely that anything in Brazil will be allowed to fall into Chinese hands and they have pretty much grabbed as much of their quota of goodwill that Australia will allow them. Ironically the Chinese have gained a toehold in Canadian iron ore production via the recent capital injection into Consolidated Thompson (CLM.to) which gave them 19% of the capital and eventually 25% of the equity in CLM's Bloom Lake project. The most prospective place that we see for the Chinese in iron ore is Peru where Cardero Resources (CDY) has massive magnetite dunes that have been the subject of on-again/off-again Chinese interest.

Nickel: this metal is going cheap at the current time and is one that the Chinese could even buy onshore assets in Brazil, Canada or Australia. Rather shortsightedly they don't seem all that interested (though they got some second tier assets as part of OZ Minerals). What are they waiting for? We would have to laugh if they waited for the price of nickel to ramp up (pushed by themselves??) before they decided to scurry after the multifarious assets available in this space.

Conclusion

The denizens of the LME have been complaining for most of this decade about manipulation of base metals prices. For a brief while they were unnerved by tsunamis of hedge fund cash that pushed nickel to crazy levels (and uranium also but in its own even more opaque marketplace). However some rule changes swiftly knocked the hedge funds into shape and in any case they were never seen as monolithic manipulators, more like a large flock of well-resourced sheep all moving in one direction. The Chinese were a different think altogether. They like everyone to know that they were “the” buyers in the market and everyone was dependent upon them. If that was true then surely the falls of late 2008 would not have been as steep. Certainly though they were big swinging things in the LME and used their cash and their metals stocks to create an effect of domination. We have long heard how “smart” the Chinese are and maybe they collectively are but in the metals and mining equities markets we have seen no sign of this wisdom. The moves in the metals markets were klutzy to say the least. The moving of sizeable amounts of zinc in and out of the LME warehouses became tiresome and totally transparent. The misinformation about copper usage, shipments and “massive stockpiles” on the docks in China strained credibility over and over again. The latest wave of manipulation has now scored a stunning own-goal in derailing the Rio Tinto deal and we could not be happier. Maybe the Chinese should outsource their commodities trading to a Western investment bank (Goldilocks anyone? Then everything could be manipulated in the one place).

In the wake of the Rio debacle, the OZ deal was saved by the skin of its teeth. An era has ended and a particularly promising window of opportunity has slammed shut. Stockpiling has backfired. Investors wanting to play the Chinese M&A “spot the target” game will need to narrow down to the shrinking pool of geographic areas where resource nationalism is still not strong enough to resist the Chinese wall of money. When it comes down to it, the Chinese will have to play by the same rules as everyone else. Some produce metals efficiently and others consume and transform metals efficiently. The Chinese had best stick to their knitting and leave global mining to others.

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