Mining mega-mergers

Some miner concerns

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China muscles in on a big deal

EVERYTHING to do with mining is impressively vast. It is an industry that makes huge holes in the ground and relies on trucks with tyres the size of houses. In recent years, thanks to China's rapid industrialisation and its voracious appetite for metals, mining companies have also produced mammoth profits, boasted gigantic valuations and undergone a series of outsized mergers and acquisitions.

BHP Billiton, an Anglo-Australian company that is the world's largest mining firm, is trying to do the biggest deal yet. On February 5th, just before a deadline imposed by British regulators, it increased its offer for Rio Tinto, the industry's number three. Having offered three of its shares for each of Rio's last November, BHP raised its offer this week to 3.4 shares, valuing its rival at $147 billion. Rio quickly rejected the revised offer. This is not the only big deal in the offing: Vale, a Brazilian firm and the industry's number four, has offered to pay $90 billion for Xstrata, ranked sixth.

The two main motivations behind such deals are scale and diversification. Bigger companies benefit from economies of scale: BHP reckons that buying Rio Tinto and merging the two firms' operations, in particular those at Pilbara, an immense iron-ore deposit in Australia, could result in annual savings of $3.7 billion within seven years. The combined firm would also be strong in aluminium, uranium and coking coal.

But too great an emphasis on a single commodity makes a company vulnerable to sudden price drops, so many mining deals are driven by a desire to diversify in order to spread risk and reduce volatility. That is what why Vale, the world's leading producer of iron ore (though BHP and Rio together would be almost as big), wants to buy Xstrata. The Brazilian company has already built up an impressive nickel business, and Fraser Phillips of RBC Capital Markets, a Canadian bank, says acquiring Xstrata would propel Vale into the big league in copper and coal, too.

But now a further ingredient has unexpectedly been added to the dealmaking mix. In an audacious move on February 1st, Chinalco, the state-owned parent of China's biggest aluminium producer, teamed up with Alcoa, an American firm, to buy a 9% stake in Rio Tinto for $14 billion. (Alcoa contributed $1.2 billion to the investment.) Though the precise motivations behind China's largest-ever foreign investment are unclear, the timing was certainly not the “coincidence” that Chinalco claimed. By taking a stake in Rio, China evidently hopes to be able to influence the outcome of BHP's attempted takeover.

Chinalco seems to have hoped that paying a high price for its strategic stake in Rio would discourage BHP from increasing its bid. (The implied valuation would require BHP to offer four of its shares for each one of Rio's.) If so, its gambit failed. But since BHP's takeover would be conditional on antitrust approval, which could take months, Chinalco has a number of options in the meantime. It could increase its stake still further, launch a full bid for Rio itself or hope that an even higher offer from BHP will enable it to walk away with a handsome profit.

The most likely explanation lies in the potential pricing power that a combined BHP-Rio would have over iron ore. This has petrified China's steelmakers and prompted Chinalco's intervention. Iron ore is vital to China's economic expansion, and much of the ore from Pilbara ends up in China. Negotiations between steelmakers and the world's three main iron-ore producers (BHP, Rio and Vale) to set annual benchmark prices for ore, which are under way, are said to be particularly fraught this year. China accepts that prices must rise, but not by the 50% or more that producers want. Last month several of Vale's shipments of ore to China were delayed, which increased the pressure. The Chinese may have seen this as a taste of things to come.

Part of the problem is that the miners' own memories of bad times have led them to behave in ways that have stoked China's worries. Mike Oppenheimer, the boss of Ferrexpo, a mining firm based in London, points out that 20 years ago, at the sniff of a price rise, miners would overinvest in new capacity—and prices would duly slump again. Mining companies have since become more cautious and expansion has been more careful, which helps to explain why meeting burgeoning demand in the short term has been difficult. Both BHP and Rio Tinto have ambitious plans to boost ore production at Pilbara.

As well as taking an interest in the BHP-Rio battle, Chinalco is also rumoured to be interested in taking a stake in Xstrata, to influence Vale's takeover attempt. So Chinalco would appear to be adopting the strategy of the big listed mining companies in one respect at least. It has built a copper business alongside its aluminium activities, and its stake in Rio has the effect of diversifying its portfolio (as will any future stake in Xstrata). Russia's Rusal, a leading aluminium producer, which is trying to take over Norilsk, a big Russian nickel firm, is also said to covet a slice of Xstrata for similar reasons. The potential for intrigue and drama, it seems, matches the rest of the mining industry in scale.