The University of Nottingham

China Policy Institute

Briefing Series – Issue 51

CHINALCO AND RIO TINTO:

THE LONG MARCH FOR CHINA'S NATIONAL CHAMPIONS

Shujie YAO and **Dylan SUTHERLAND**

July 2009

International House

University of Nottingham

Wollaton Road

Nottingham NG8 1BB

United Kingdom

Tel: +44 (0)115 846 7769

Fax: +44 (0)115 846 7900

Email: CPI@nottingham.ac.uk

Website: www.chinapolicyinstitute.org

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EXECUTIVE SUMMARY

1. The US$19.5 billion deal of the Aluminium Corporation of China (Chinalco) with Rio Tinto (Rio) eventually failed to materialize. On 5 June 2009, Rio unilaterally abandoned the deal, accepting instead an offer from BHP Billiton.

2. Chinalco's offer to Rio was first made in Feb 2008, in the form of a US$14 billion purchase of Rio's stakes. This was stepped up by a strategic partnership offer of US$19.5 billion in Feb 2009.

3. Yet, during the long FIRB (Australia's Federal Investment Review Board) review process, Rio's share price recovered and shareholders started to question the terms Chinalco was offering.

4. As the FIRB review dragged on, prospects for global commodity markets improved dramatically. In the end, Rio unilaterally pulled the plug, just one week before a FIRB meeting to decide on the deal.

5. At face value, like the China National Offshore Oil Corporation (CNOOC)'s failed bid for the big US oil company Unocal in 2005, Chinalco's offer to Rio appears to be mainly about China securing natural resources in other parts of the world.

6. At a deeper level, however, it illustrates the intensifying efforts of China’s national champions to catch-up with the world’s leading transnational corporations (TNCs).

7. In the last two decades, a number of Chinese big business groups have emerged on the back of strong governmental supports. These “national champions” numbered around 150 by 2008.

8. Their assets, sales and R&D expenditure grew on average at a staggering 25 per cent a year, and their profits, around 40 per cent a year. They have led in China’s internationalisation efforts, accounting for 40% of the country’s total OFDI (Outflow FDI) in 2007.

9. The global financial crisis has left many Western TNCs severely weakened, presenting Chinese large state-owned enterprises with an unprecedented opportunity to “go global” through acquisitions.

12. In this light, Chinalco may have lost one, albeit important, battle. In the years to come, however, the world will see more similar moves by other Chinese firms. The Long March of China’s national champions toward the world’s top firms has only just begun.

Chinalco and Rio Tinto:

The Long March for China's National Champions*

Shujie Yao and Dylan Sutherland

The Chinalco–Rio Deal

1.1 Rapid growth over three decades has made China thirsty for oil and raw materials. In a drive to secure a stable and cost-effective supply, policy makers have encouraged national champions to buy or heavily invest in foreign companies, including gigantic Transnational Cooperations (TNCs). The recent attempt by Aluminium Corporation of China's (Chinalco) to purchase stake from and form a partnership with Australia's Rio Tinto (Rio), the world's second-largest mining company, was just the latest of the episodes.

1.2 In February 2008, Chinalco paid US$14 billion to buy a 9 per cent stake in Rio. The purchase, representing China's largest foreign investment ever, effectively killed off BHP's bold US$147 billion move for Rio. To step up its effort, as Rio was desperate for a further capital injection to pay off its huge debts incurred after buying Canada's Alcan in 2007, in February 2009 Chinalco pencilled in a further US$19.5 billion strategic partnership with Rio (see Table 1).

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* This paper has been accepted for publication at The China Quarterly, September 2009.
Shujie Yao is Professor of Economics and Chinese Sustainable Development, and Head of the School of Contemporary Chinese Studies at The University of Nottingham, UK. Dr. Dylan Sutherland is a lecturer at the School of Contemporary Chinese Studies at Nottingham.

Table 1: Chinalco, Rio Tinto and BHP Billiton's struggle for control

Important dates	*Event*
October 2007	Rio Tinto bought Alcan for US$38.6 billion, incurring US $34 billion of debts
November 2007	BHP attempted to buy Rio on a 3:1 all-share swap
February 2008	Chinalco with the US's Alcoa invested US$14 billion to buy 9 per cent of Rio's shares
August 2008	Chinalco raised its stake in Rio to 11 per cent
November 2008	BHP abandoned its plans to buy Rio due to Chinalco's intervention
February 2009	Chinalco agreed to invest another US$19.5 billion in Rio: US$12.3 billion for minority stakes in iron ore, copper and aluminium assets and US$7.2 billion for convertible bonds to take its equity stake in Rio to 18 per cent and two non-executive seats in Rio's board
5 June 2009	Rio unilaterally abandoned its deal with Chinalco and proposed an alternative, to raise US$15.2 billion through right issues and US$5.8 billion from BHP Billiton by forming a joint venture with the latter in western Australia

1.3 For a while, it appeared Chinalco had got what it wanted, through a cleverly orchestrated set of moves. Yet, during the long FIRB (Australia's Federal Investment Review Board) review process, Rio's share price recovered and shareholders started to question the terms Chinalco was offering. In particular, the dilution of existing shareholders' equity caused consternation. Shareholders, moreover, increasingly questioned whether it made sense to ally with the single largest customer – a Chinese company.

1.4 Alternatively, a merger with BHP Billiton in the all-important iron ore reserves in the Pilbara region of Western Australia would lead to the formation of a global duopoly in seaborne iron ore. Huge cost savings, estimated at around US$10 billion, through the sharing of rail and port infrastructure, could also be achieved. The combination of the Pilbara assets in a single joint venture held a powerful industrial and market logic.

1.5 Meanwhile, as the FIRB review dragged on, prospects for global commodity markets improved dramatically.[1] By 5th June 2009 the Chinalco-Rio deal finally ran aground. Chinalco's initial offer, made at the bottom of the market, was rejected – even at the expense of a US$195 million escape fine – as the conversion rate on its convertible bond looked less and less appealing to shareholders.

1.6 Instead, a rights issue for US$15.2 billion and a joint venture in the Pilbara mines with BHP, netting Rio US$5.8 billion, was proposed. This would clear its short term debts incurred in the Alcan misadventure. Conveniently, it would also greatly strengthen its bargaining position with its major customers – including Chinese steel makers.

Chinalco and the Global Metal Market

2.1 Chinalco's bid for Rio must be seen in the light of sustained and rapid growth in the largest developing economies which led to an unprecedented boom in metal

[1] Ironically, this was in part driven by China's own massive stimulus packages.

prices.[2] This boom left many mining companies, particularly the largest, cash rich. Moreover, credit through the banking sector was readily available. As these mega companies looked to quickly expand via acquisition, they avoided the lengthy time required in developing new mines but instead initiated an unprecedented spate of global mergers and acquisitions.

2.3 Between 1995 and 2006 almost 20 "mega-mergers" exceeding US$1 billion each took place.[3] Concentration in the metal mining industries increased significantly. By 2006 the ten largest miners controlled 33 per cent of the world's total non-energy minerals output, up from 26 per cent in 1995. The degree of concentration rose fastest among minerals including iron ore (from 44 to 52 per cent) and copper (from 51 to 58 per cent), resources critical for China's development.[4]

2.4 By late 2007, even as the global credit crisis was beginning to unfold, the merger wave reached its zenith. An endgame in the scramble for global resources started to play itself out. Firstly, Rio successfully bought Alcan for US$38.6 billion. As a result Rio, as well as being a major iron ore and copper producer, became the world's largest producer of aluminium and bauxite. Then,

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[2] World Bank, "Global Economic Prospects: Commodities at the Crossroads," in World Bank (ed.), *Global Economic Prospects* (Washington DC: World Bank, 2009), pp. 196.

[3] UNCTAD, "World Investment Report 2007: Transnational Corporations, Extractive Industries and Development,"World Investment Report (New York and Geneva: UNCTAD, 2007), pp. 323.

[4]Ibid.

only shortly after this huge, debt-fuelled acquisition, Rio itself became a target of BHP Billiton.

2.5 BHP being the world's third largest producer of iron ore and second of copper, with Rio Tinto the second and fifth, the merger would have created the largest single producer of iron ore (with one third of the world's iron ore) and copper, as well also as aluminium and power-station coal, in the world.

2.6 At this point, there was a real danger the resources China needed for its development would become forever tied up in just a few large global companies. China's massive demand for metals such as iron, steel and copper, is driven by its breakneck economic growth. Between 1990 and 2007, for example, pig iron, crude steel and rolled steel production, increased nearly tenfold. By 2007, 15 of the top 50 steel producers in the world were Chinese.[5] China now produces around half of the world's steel output.

2.7 The global consolidation of the metals mining threatened to push up the costs of China's development considerably and in the worst possible case, even bring it to a halt. In this light, China had to act. Chinalco, a Chinese national champion, became its chosen vehicle. As with China's other national champions, the group has grown through state support and the acquisition of numerous smaller domestic rivals. As a result, Chinalco has become the largest aluminium

[5] World Steel Association, "Top steel producers 2007," (Brussels: World Steel Association, 2009), available from http://www.worldsteel.org/. In 1990, by contrast, there were none.

corporation in China, with monopolistic power in price-setting both downstream and upstream in its wide range of products.

2.8 In February 2009, moreover, the State Council released a detailed plan in which Chinalco was selected to be among three to five groups leading domestic consolidation of the non-ferrous metals industry. Like many of China's national champion groups owned by the State-owned Assets Supervision and Administration Commission (SASAC), it has been supported in its bid to increase its profits in recent times.

2.9 In 2008, owing to the collapse in demand for aluminium, Chinalco's profits dropped by 99 per cent in 2008. In addition, its original 2008 investment in Rio lost 70 per cent of its market value – about US$10 billion, and it will incur net losses this year. Despite these losses, nevertheless, four of the biggest Chinese state-owned banks – two are state policy banks – lined up to lend Chinalco US$21 billion, more than needed for its deal with Rio.

2.10 These banks charged very low interests, only 94.5 basis points above the six-month's London inter-bank offered rate (LIBOR) and did not set a time for Chinalco to pay back the loans. Only recently, by contrast, BHP Billiton issued ten-year bonds which had to bear interest at 390 basis points above the six-month LIBOR.[6] This type and scale of lending activity is possible only in China,

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[6] Zhen Yang, "Easier loans lead to more M&As," *China Daily*, 20th April 2009, p.4.

where the state-owned banks and businesses are treated as the left and right arms of the state to achieve its national long-term development objectives.

2.11 Unsurprisingly, Chinalco's international expansion, as for many other Chinese groups, cannot be fully explained by existing theories concerning the key motivations for foreign direct investment.[7] Existing theories suggest that investing firms should possess some kind of advantages over their host-country competitors, be it technology, brand or management skills. Comparing Chinalco with Rio, however, the former does not appear to have any such advantages. It is actually smaller and less profitable.

2.12 But if we look at Chinese policy makers as using Chinalco simply as a vehicle for national security and development, the high degree of asset specificity – China's total dependence on iron ore to develop – fully explains its desire to vertically integrate with Rio.

China's National Champions

3.1 Chinalco's bid for Rio also illustrates a larger and arguably more important story, concerning the international expansion of China's national champions after the financial crisis. China's policy makers, since early on in their economic reforms,

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[7]See for example R. Morck, B. Yeung and M. Zhao, "Perspectives on China's outward foreign direct investment," *Journal of International Business Studies*, Vol. 39, (2008), pp. 13, and J. Child and S. B. Rodrigues, "The Internationalization of Chinese Firms: A case for Theoretical Extension?,"Management and Organization Review, Vol. 1, No. 3 (2005), pp. 19.

have worked hard to turn around their state owned businesses. Ultimately, they hold the long-term strategic aim of developing their own national champions into internationally competitive TNCs.

3.2 China's vice-premier, Wu Bangguo, noted more than a decade ago: *"In reality, international economic confrontations show that if a country has several large companies or groups it will be assured of maintaining a certain market share and a position in the international economic order…..[N]ow and in the next century our nation's position in the international economic order will be to a large extent determined by the position of our nation's large enterprises and groups."*[8]

3.3 By 2008 around 150, including Chinalco, had been selected as national champions to receive strong state supports. They had also grown at amazing speed, gaining privileged access to stock market listings and bank finance, among other things. Over the past decade their assets, sales and R&D expenditure grew on average at a staggering 25 per cent a year. Their profits grew even faster – at around 40 per cent a year.[9] As would be expected, they

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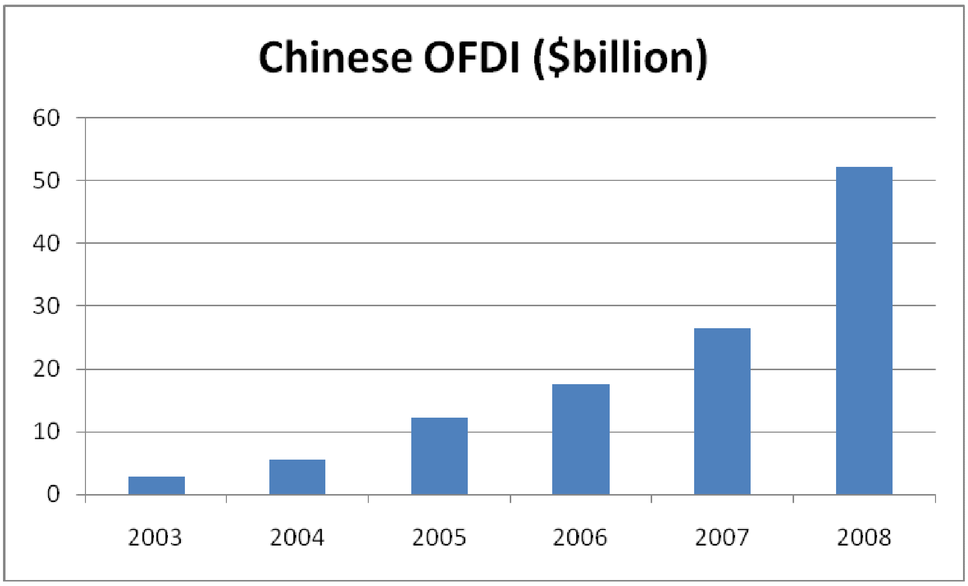
[8] D. Sutherland, "Policies to Build National Champions: China's 'National Team' of Enterprise Groups,"in P. Nolan (ed.), *China and the Global Business Revolution* (New York: Palgrave, 2001), pp. 1092. In this context Wu has also commented: "America, for example, relies on General Motors, Boeing, Du Pont and a batch of other multinational companies. Japan relies on six large enterprise groups, and Korea relies on 10 large commercial groupings."

[9] SSB, *Large Corporations of China 2007,* (Beijing: China Statistics Press, 2008).

have led in China's internationalisation efforts, accounting for 40% of the country's total OFDI in 2007, and even higher shares in previous years.[10]

3.4 The strong state backing for overseas expansion is illustrated by the fact that China is bucking the world trend. Even as global flows of FDI have started to rapidly contract, Chinese outflows continued to rise (see Figure 1). Six years ago, direct foreign investment originating from China was negligible, by 2008, it had rocketed to US$52 billion. Had Chinalco's deal been successful, total OFDI from China would have again doubled in 2009. Despite Chinalco's failure, this trend is likely to continue.

Figure 1: growth of China's outward foreign direct investment



[10] D. Sutherland, "Do China's "national team" business groups undertake strategic-asset-seeking OFDI?," Chinese Management Studies, Vol. 3, No. 1 (2009), pp. 13.

Source: 2007 Statistical Bulletin of China's Outward Foreign Direct Investment (Beijing: Mofcom, 2008); Yan Zhou, "M&A prices look right to many in their plans to go global," *China Daily*, 6 April 2009.

3.5 There are two important reasons why we can expect this. Firstly, such increases will increasingly be driven by China's banks. Four of the world's ten largest banks are now Chinese, including the three largest in terms of market capitalization.[11] By mid 2009, interestingly, US banks had a bigger proportion of state ownership and larger debts. In December 2008 restrictions were lifted on China's banks, allowing them to lend for overseas acquisitions for the first time, and to actively support the "go global" policy.

3.6 Secondly, owing to the financial crisis, China's national champions have also seen a dramatic increase in their financial size relative to their global counterparts. In 1997 China's trial national champion groups had profits totalling only three per cent of the top 100 businesses in the Fortune 500. By 2008, however, after a record fall in those of the Fortune 500, their profits jumped to around 40 per cent.[12] Symbolically, by May 2009 PetroChina had become the largest company and ICBC (Industrial and Commercial Bank of China) the largest bank in the world by market value.

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[11] Lex, "*No dim sum*', Financial times, 16th March 2009, p. 24.

[12] Fortune, "Fortune 500," Fortune (CNN Money, 2009), SSB, *Large Corporations of China 2007,* (Beijing: State Statistical Bureau, 2009).

3.7 Until recently, the prospects for China's national champions were considered bleak.[13] The global financial crisis, however, provides an unforeseen opportunity for them. Chinalco may have lost one, albeit important, battle. There will, however, surely be more to come, as other groups attempt similar moves elsewhere, leveraging their healthier balance sheets and easier access to credit through the banking system.

3.8 Minmetal's (another of China's national champion mining groups) US$1.38 billion successful bid for Oz Minerals (another large Australian mining company), only one week after the breakdown of the Chinalco–Rio partnership, is just one, albeit smaller, example. Other examples may include Beijing Automobile Industry Corporation (BAIC)'s attempt for Ford's Volvo, Geely's interest in GM's SAAB and Tengchong's bid for GM's Hummer. All this signals that it is only the beginning for China's national champions in their long march to become truly global.

Towards Global Champions: A Long March Cut Short?

4.1 The Rio Tinto drama may appear to be a failure for Chinalco, and for China's economic ambition more generally. The complex deal (outlined in a 600-page document) was bound to be subject to a long review. As such, it opened the way for closer scrutiny and public discussion, missing the small window of

[13] Peter Nolan, *China and the global business revolution* (New York: Palgrave, 2001), pp.1092.

opportunity that was available. In February 2009, Chinalco had what seemed an all powerful bargaining position. It may have tried, however, to push this advantage too far. It overlooked the alternative options that existed for Rio, as well as the tenacity of BHP.

4.2 If it had made a straightforward equity deal, instead of the complex joint venture arrangement and convertible bond, it may well have brokered a deal. As a result, Chinese steel makers now find themselves in an awkward and unenviable position, with mounting losses and facing even harder future negotiations – now pitted against a possible global duopoly in seaborne iron ore. Chinalco simply failed to get the deal it wanted.

4.2 But there are more to be taken note. Firstly, Chinalco's initial purchase of Rio's shares, through a special vehicle formed with Alcoa in Singapore, was widely admired for blocking the massive BHP Rio deal. Its approach showed signs of sophistication and finesse. It was, and remains, successful in scuppering this potentially, much bigger and more harmful deal.

4.3 Futhermore, the fine detail of its failed bid was also cleverly designed to give it considerable strength in the marketing and negotiation of sales contracts of the iron ore produced at Rio's Pilbara mines, vital to keeping prices low to China's steel makers. This, indeed, may have been its ultimate objective. A simpler equity deal may not have been able to achieve these ends.

4.4 Secondly, Chinalco's bid failed primarily on commercial terms, not political ones.[14] In the end shareholders saw more value in the BHP Pilbara joint venture, coupled with a non-dilutive rights issue. There is a very strong economic logic, given the cost savings and also market power it creates, for this joint venture. As such, it was always going to be difficult for Chinalco to achieve its ends.

4.5 It must be kept in mind, however, that there is still no guarantee that competition authorities will grant approval for the Rio-BHP deal. As such, it may still be too early to say whether Chinalco has failed in one of its initial objectives – blocking the merger of Rio and BHP's iron ore operations. The World Steel Association, representing the interests of largest global steel companies, has already formally asked the European Competition Commission to investigate the joint venture deal.

4.6 Japanese authorities are also concerned. The initial objections to the larger Rio BHP tie-up back in 2008 also centred, in part, on the Pilbara operations. The current reincarnation of this deal envisages merging the mining operations but maintaining two separate marketing businesses. Steel industry executives, however, have already referred to this solution as "the devil in disguise." The Western Australian government is also concerned about the joint ventures intentions to avoid certain royalties.

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[14] All companies, even big foreign private companies – as China's recent rejection of Coke's bid for the famous Huiyuan juice brand shows – may face similar political obstacles.

4.7 Finally, looking at the bigger picture, the Chinalco/Rio debacle demonstrates that the real prospects for China's national champions are far brighter than they were before the financial crisis. Rio only became vulnerable in the first place because of the crisis. Whereas Rio could not pay off its debts, Chinalco, by contrast, was strongly supported by China's state banks. These banks will continue to back more national champion groups in their forays overseas, as China looks to turn its monetary reserves into hard assets. By contrast, it will still take a number of years for the Western banking system to recapitalise, so restricting some of the financing options for other TNCs competing for these assets.

4.8 Moving to the real economy, the balance sheets of China's other national champions are now also far stronger than they have ever been compared to the TNCs they hope to catch-up. China continues to grow while the developed market economies shrink. As such, an unexpected window of opportunity now presents itself. The long march for China's national champions, therefore, has not been cut short, but in fact, has only just begun.