

Wednesday 1 July 2009

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INQUIRY INTO FOREIGN INVESTMENT BY STATE-OWNED ENTITIES

PRESENTATION NOTES – W.A. EDWARDS

1. Global natural asset grab occurring, with ownership increasingly dominated by sovereign wealth funds and national companies (for example oil and gas). An age-old strategy.
2. History is a better teacher than half-baked economic ideology. (All great economic powers controlled assets by various forms of colonisation. No accident that previously 'colonised' countries such as China have recently limited outside access to their own assets whilst attempting to gain control of those in other countries. China recently accused of 'choking' other countries' industries by restricting exports of critical raw materials and partially processed raw materials – dangerous, economically and strategically.)
3. Chinese strategy to control supply chain and prices. (Accidental comment by Chinese iron and steel official re Rio and BHP. Attempt to gain control of Australian mid-west iron ore region. 600 page side agreement with Rio extended control.)
4. China's growing arrogance and hypocrisy is offensive. (Accuses other countries of protectionism and attempted monopolisation while, for example, it limits access to its own assets (e.g. minerals, Coca Cola case) and is itself a monopolist (e.g. rare earths, where it owns 60% of world reserves and produces 90% of processed rare earths, vital ingredients in electronics and military applications. Has now attempted to gain control of Australia's Lynas Corporation, with world's largest undeveloped rare earths deposit at Mt Weld.)
5. Chinese government claims 'independence' for its entities whilst actively orchestrating co-ordinated global takeover activity. (Beijing's National Development and Reform Commission says Chinese companies must clear foreign takeovers with central authorities first so as to combine corporate and "national strategic planning" interests.) China Inc. is a reality, not a figment of a paranoid imagination.
6. Chinese government funnelling huge wads of money via state owned banks to Chinese entities to enable foreign takeovers.
7. Danger that Chinese government will use existing Australian beach-heads as conduits for foreign reserves, enabling rapid take-up of Australian assets (mining leases, etc).
8. "National Interest Test" a weak instrument. (Acid test of a truly strong economy is ability to consistently run current account surpluses. Australia hasn't run one since 1983 deregulation, in spite of massive foreign investment here and despite an unprecedented boom. Problems include excessive consumption of imports, interest on foreign borrowings, dividends to foreign owners of our assets.)
9. Specific Issues. (Life-of-mine contracts; vertical integration; capital intensive nature of mining and use of equipment/services imported from owner-countries; worthless promises made at acquisition time; manipulation of prices; transfer pricing and use of high gearing).
10. Centuries of experience reveal that the rich accumulate productive assets while the poor either never had them or lost/sold them to others. Australia has sold/is selling off majority interests to foreign buyers.

Note: While other nations/regions such as Singapore and the Middle East are relevant, I have focussed on China, because of its potentially much greater impact on us.

China's M&A grand strategy

Further to reports this morning and yesterday of China's growing interest in foreign takeover targets like Brazil's **MMX** and possibly **Xstrata** and **Vale**, Beijing's National Development and Reform Commission has put companies on notice that they must clear foreign takeovers with the central authorities first so as to combine corporate and "national strategic planning" interests. While this is nothing new it demonstrates perhaps a growing move back in China to centralisation. While companies like **Chinalco** may claim to be independent and "commercial", to the government at least they are more appendages of the state. Another very recent development is the growth in so-called "M&A loans" from China's state-owned banks. While Australian companies often have to cite things like "debt reduction" "general purposes" when raising money from risk-averse capital markets (and you can almost forget about M&A loans from our banks), China's banks have extended the equivalent of \$US1.42 billion in these M&A loans since last Monday, according to *Xinhua*.

Has the trade war begun?

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The United States and the European Union have filed complaints against China at the World Trade Organisation (WTO) on June 23 accusing Beijing of placing export restrictions on raw materials and partially processed raw materials critical to many industries. The nine materials cited by the United States are bauxite, coke, fluorspar, magnesium, manganese, silicon carbide, silicon metal, yellow phosphorus and zinc. The complaint accuses China of restricting exports, thus creating an unfair advantage by contributing to disparities in prices of these precursor materials inside and outside China. The European Union also complained that the restrictions could undercut some 4 per cent of European industrial production if the resources are no longer easily accessible from Chinese suppliers.

Beijing has countered that its export restrictions are perfectly legitimate under WTO regulations, with a Ministry of Commerce official telling China's official *Xinhua* news agency the restrictions were part of environmental protection and energy conservation measures approved under the 11th five-year economic plan (2006-2011). Zhao Jinping, senior researcher and deputy chief of the Research Department of Foreign Economic Relations of Development Research Center – the main consulting institution for China's State Council – added that the West's demands on China were "conflicted". He accused the West of saying Beijing should work to protect the environment and reduce excessive energy consumption while simultaneously criticising Beijing for taking measures to reduce energy-intensive polluting industries like those being restricted.

At its core, the focus of the US and EU complaint is the manipulation of prices for several critical primary commodities. Bauxite is used for aluminium production, which in turn is used in anything from soda cans to electronics. Coke is a primary ingredient in producing steel, while magnesium and manganese have numerous uses. (Both magnesium and manganese are also used in the steel manufacturing process, as well as in creating alloys with steel and aluminium.) Silicon carbide is used as an abrasive and in high-end brake discs, while silicon metal is used for, among other things, the production of silicon wafers for semiconductors and photovoltaic cells. Yellow phosphorus is used in flame retardant materials, and zinc is used in galvanisation of steel, in battery production, and as a major component of brass.

China is a major producer of several of these commodities (for example, China was the world's largest producer of zinc in 2006, nearly double the output of its next-nearest competitor, Australia), making its export restrictions significant in the overall global supply-and-demand balance. The accusation is that by restricting exports, China reduces supply internationally, driving up international prices. It also maintains that China has a glut of these resources, comprising both domestically produced and imported commodities, so Chinese domestic prices are artificially low due to oversupply. China thus not only has the advantage of lower precursor prices, it also can supply lower-priced secondary products like steel and raw aluminium to international consumers. This gives it additional market share and potentially drives out higher-priced overseas competitors.

China certainly can make a case for the environmental side of its export restrictions. (Beijing has been working to try to consolidate numerous industry sectors to reduce waste, cut energy consumption and address pollution problems.) But the restrictions and their 'unintended' consequences regarding resource availability fit with Beijing's longer-term program of seeking ways to insulate China from the vagaries of international commodity pricing. China has been buying up resources, and buying or investing in resource producers and mines around the world. This is part of its efforts to maintain control of the entire chain from extraction to Chinese manufacturing as a way to mitigate price and availability changes. China also has been stockpiling natural resources as a further buffer. Restricting exports of key industrial commodities gives Beijing the ability to better regulate resource prices at home; if it gains additional influence in shaping international prices, all the better from China's point of view.

As the case enters the WTO process, it is unclear whether China can make a strong enough case on environmental grounds to counter the charges effectively, or whether some compromise will have to be made. China has become adept at using the WTO mechanisms to avoid significant punitive trade actions by the United States and others,

exploiting the time it takes to process a WTO complaint to gain ground before compromising. Perhaps not coincidentally, on the same day the United States filed its complaint, Beijing sent a letter to the WTO complaining about US restrictions on the import of Chinese poultry – demonstrating China's willingness to use the WTO for its own ends as well.

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Kagara

Copper and zinc group **Kagara** has formerly announced its plans to raise between \$150 and \$262 million, of which \$127 million will be underwritten by **Macquarie Capital** and **Southern Cross Equities**. The arrangement, in which **Goldman Sachs JBWere** also makes an appearance as corporate adviser, involves a cornerstone investment from the very plural **Goldland Holdings Company**, a subsidiary of **Guangdong Foreign Trade Group**, a subsidiary of the Hong Kong-listed **Guangdong Investments Ltd**, which also owns **Guangdong Asset Management Company** but has nothing to do with **Guangdong Rising Assets Management**. **Guangdong Rising** last month made a cornerstone investment in **Kagara's** rival **PanAust**. The **Goldland/Guangdong** deal is subject to shareholder and regulatory approvals here and in China and will be the lesser of \$62.5 million or 15 per cent of **Kagara**. However, post-offer **Guangdong** may increase its stake to 19.9 per cent. The placement was made at 60 cents a share, around half of **Kagara's** closing price on May 29 when it went into the pre-open.