

Old fashioned leverage...

(China takes out its wallet)

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One of our earliest editorials (in what was then a monthly only publication) was entitled "China Beckons". This was after David's first trip to China in 1995, at which time the stirrings of the country's boom economy was evident in major city core areas, but highway travel still often involved a slow progression around ox-cart and foot traffic. During that trip the central government's mining ministries made it plain they were expected to make their own way while government funds were directed elsewhere. A more appropriate title these days would be "China Buys".

While western banks continue to undergo a period of deleveraging and retrenchment, Chinese firms are making use of the oldest form of leverage – available cash in a down market. That has come to the aid of Rio Tinto (RTP-L) which went into debt to purchase Alcan (Aluminum Company of Canada) in 2007. Chinalco (Aluminum Company of China) has agreed to take various minority stakes in aluminum, copper and iron producing Rio subsidiaries for US \$12.3 billion, which is a reasonable sum for interests that earned \$2.2 billion in 2008. Added to this are \$7.2 billion of convertible bond purchases, which at significantly above market strike prices would bring Chinalco's stake in Rio Tinto Group to 18%.

The Rio Tinto share price was held aloft by a hostile bid from BHP-Billiton during the strongest part of the mining finance market. Furthering its association with Chinalco makes the obvious point that company management would rather be aligned with its growth market, rather than against it as the BHP bid would have done. Rio Tinto is debt heavy rather than floundering and could have found some other way to deal with its debt, but we think the pricing makes a point about Chinalco and by extension other Chinese companies looking at global resource assets. The focus is on gaining access to resources, not simply taking them over.

A US\$1.7 billion cash offer has also been arranged for China Minmetals to take over Australian base metals producer Oz Minerals (OXR-Aus). Oz, the third largest base metals company in Australia, had been halted since mid December so it could try to reorganize its debt and bring itself back into compliance. The company was the latest attempt to falter in attempting to jumpstart the Australian zinc sector. China Minmetals should have a stronger handle on the galvanizer's supply base that can be heavily influenced by small scale Chinese operations, so this move could help smooth the jagged edges in the zinc market going forward. It is also notable that one of the better copper mines in the Oz stable is within the same Laotian mineral belt that a junior followed by HRA is exploring.

The Rio Tinto-Chinalco partnership deal, and the rescue bid by Minmetals for Oz that we doubt would be bettered by a western firm, are certain to garner further discussion. Our take is they should give comfort to both others wanting to negotiate resource deals, and to regulators and legislators who have had a tough time with the only partly denationalized status of many large Chinese companies. We assume western legislators couldn't summon up the gumption to complain at this cheque writing when

many of them are in the midst of nationalizing their banking sectors, but then a degree of wishful thinking is in the job description for a resource newsletter.

It is of course the potential nationalization of large US banks, and chunks of the auto sector, that is dominating market play right now. The suggestion by Citicorp that the US government should convert its preferred shares from a debt to an equity entry at a 400% premium to market underscores that these gatekeepers continue to work behind shuttered windows. This sort of suggestion only increases potential for state sponsored take-over, if only to appease infuriated taxpayers who are buying Citi's lunch lately. The lenders and account holders of these firms need to be the focus, not their shareholders. Not even the US government can continue to blindly chip borrowed funds into failed corporations and expect to sell notes indefinitely to cover it.

Meanwhile, on the other side of the Atlantic the major European players are making a coordinated call for some form of global bank regulation. While we are not fans of over regulation, we are encouraged by the "coordinated" way in which this call is being made. Some reshaping of the global currency system is needed, and that would be much more difficult with an overly fractured Euro space. However, pushing global policy could be preceded by cleaning up continental policy initiatives. The Europeans, after all, are not in a position to cast stones since their banks suffer under even more ridiculous leverage ratios.

The larger European economies might try to bring some of the new eastern EU members into the Euro fold. These countries were encouraged to borrow in Euros ahead of joining the common currency, and their crashing local currencies are now choking off their economies. Expedited entries into the Euro system could erase some of their debt issues, and some of the bad debt issues of west European banks. Doing this would require some political courage, but then leadership is like that. Some in Brussels would argue these eastern states to not meet requirements in terms of government finances and deficit to GDP ratios but then neither to many (if any) of the core EU states this year.

Global economic policy will no longer be about going with the flow of US ideas. If Europe feels its initiatives are being ignored in North America, it will take them to Asia. We frankly doubt that Asia yet knows how it should respond to the overtures that will be coming its way. But within the resource sphere at least, it is wasting little time in securing what it will need to continue growth. For the moment a western banking system in tatters is anything but an impediment to its doing this.

There has been a leveling of new supply into the **copper** inventories. Not yet enough to suggest a bottom is at hand for the red metal, but sufficient to help stabilize its price. Bank nationalizations would garner new rounds of general selling to cover related equities losses, so we are reticent to view *anything* as having actually based. This could however signal some bolder moves back into the market once the dust had settled.

Gold and, increasingly, **silver** will continue to be beneficiaries of the uncertainties surrounding the currency market. Long time sub-sector players are waiting for a move through the old gold high. We are happy to see the price consolidating ahead of that test. We would in fact be as worried by a price spike as by a retest of the US\$930 level that was recently breached. It must be kept in mind that greenback strength means that

many non-Americans are already seeing all time highs for the yellow metal. A strong price spike due only to banking uncertainties would likely be brief.

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