CHINA INTERNATIONAL BUSINESS

Red Gold Rush

by Daniel Allen - September 2007

Phototgraph by: Phototex

At 3am on Saturday night in Beijing, most of the city's residents are asleep – save for tens of thousands of construction workers who are busy keeping apace with China's appetite for glitzy apartments, shopping malls, subway lines and power stations. A common thread runs through all these projects: copper, a metal that's growing increasingly precious.

This 24-hour demand is sucking up metal almost as fast as it can be extracted. Last year China used four million metric tons of copper, about 22% of global production, up from just 10% in 1996. In 1990, US demand for copper was quadruple that of China − now China is consuming twice as much as the world's largest economy.

New buildings are springing up at an unprecedented rate, and all of them require copper piping and wiring systems. China is currently building power plants at a rate of two per week – five times that of US power plant construction. As half of China's copper consumption currently goes toward power generation and transmission, it's little wonder that Chinese copper use continues to grow at more than 10% per year.
In addition to the power and construction sectors, continued economic development is resulting in an ever-increasing Chinese middle class, driving a huge demand for white goods that require copper. China's extensive rural electrification program is also likely to ramp up copper demand for the foreseeable future.

This massive demand means that China is now almost single-handedly driving the global copper market. According to the latest data from the International Copper Study Group, Chinese copper usage during the first four months of this year was up 38% year-on-year. During the same period, European Union copper usage rose by just 0.8%, while copper use in Japan and the US fell.

Yet while China is now the world's largest consumer of the metal, it is far from the largest producer of copper concentrate – the raw material used in the smelting process to create the finished, refined product. Consequently, the Chinese copper industry relies heavily on imports of raw copper concentrate. And as the world scrambles to supply the biggest consumer with enough raw materials, global copper prices have soared. Spot copper prices have risen fivefold over the past seven years, from USD 0.60 per pound in June 1999 to USD 3.25 in August 2007.

This China-fuelled price explosion has had a major impact on both the domestic and the international market, squeezing the margins of China's copper smelters, driving a massive investment in production and exploration from leading mining firms and sparking a spate of mergers and acquisitions in the mining industry.

SMELTING SQUEEZE

Although China's domestic copper reserves are growing – it is currently estimated to hold 5.6% of the world's copper – a report published in June by Macquarie Bank concluded that, at present, domestic copper mines can only supply around 25% of the raw copper concentrate required by smelters.

Consequently, Chinese smelting firms are scouring the globe on the lookout for concentrate. Back in 2003, nine domestic smelters formed a collective, the China Smelter Purchase Team (CSPT) to negotiate imports of copper concentrate. Members of this collective include China's largest copper smelting firm, the Jiangxi Copper Group, Tongling Nonferrous, Yunnan Copper and Jinchuan Group. Last year these nine copper smelters imported a total of 2.9 million tons of copper concentrate, accounting for more than 81% of China’s total copper concentrate imports. They also produced 1.98 million tons of refined copper, or 68% of the China’s total refined copper output, representing around 17% of total global production.

Over the past five years, China’s refined copper production has increased by around 84%, accounting for around a third of total growth in global refined production. China’s refining capacity is expected to continue to grow in 2007 and 2008, through the anticipated commissioning of over 900,000 tons of new capacity. Experts predict this could boost the average monthly output of Chinese refined copper to 300,000 tons from now until the end of 2007, up 15% on the first half of the year.

Jiangxi Copper, China’s top smelter, started production at a new 300,000 ton-a-year refining facility in May this year, and recently began building a new 200,000 ton-a-year facility. Xiangguang Copper’s 200,000 ton-a-year plant in Shandong and Yunnan Copper’s 100,000 ton-a-year plant in Inner Mongolia began operating in July.

There is, therefore, plenty of smelting capacity. The problem for domestic producers is that although domestic demand for their product remains high, their margins are being squeezed. While international copper prices have soared, local end-product prices have increased at a much slower rate. Consequently, smelters are struggling to remain profitable in the face of high import costs and a relatively low domestic price for refined copper.

A number of major Chinese copper smelters now claim that they are unable to cover the cost of buying and processing imported raw material on the global market and are losing money as a result. Zou Shaolu, chairman of Yunnan Copper Group, told the Xinhua news agency in July that smelters were losing more than RMB 2,000 on every ton of electrolytic copper as a result of the current market conditions. Yang Jun, director of the CSPT, told Xinhua that his members would decrease output by 10% during the second half of this year unless the fees for processing the raw imported concentrate were raised.

Such a move would force Chinese copper buyers to seek refined copper on the global market, further inflating world prices and cutting into end users' margins as well.
Another option for smelters would be to fall back on stockpiled reserves. During the second half of 2006, smelters cut their imports of concentrates and used up cheaper stocks to counter the mid-year surge in metal prices. In addition, the government has been actively replenishing its stockpile during the first half of this year. China's copper stocks increased almost threefold between January and the end of July this year to 90,089 tons.

However, Allan Trench, copper research manager at CRU Analysis, warns that if Chinese smelters decide to rely on reserves, these will soon be exhausted. "Concentrate stockpiles are not large enough to stem the requirement for ongoing imports," he told CIB.

Chinese smelters face additional problems in their dealings with overseas suppliers.
Non-Chinese mining companies, such as Oxiana, Rio Tinto and BHP Billiton, have all recently cut contract fees paid to smelters for processing copper concentrate in an effort to increase profitability. Although in some cases the cuts are being introduced in stages as various contracts roll over, many fee reductions have been in the region of 50% or more. On top of this, most mining groups have recently scrapped so-called price participation clauses, which allowed smelters to share in rising copper prices.

Phototgraph by: Chinafotopress

In this challenging climate, and boosted by China's healthy trade surplus, which soared to USD 26.91 billion in June this year, Chinese mining firms have been sizing up primary mining producers across the globe in order to sidestep the high price of importing unrefined product from overseas outfits.

Last year, Beijing-based China Minmetals Corporation, China’s biggest state-owned metal trading company, signed a USD 2 billion deal with Chilean mining company Codelco to mine copper resources in Chile, which is the world's largest copper producer. The deal represented the first direct foray by a Chinese mining firm into the Chilean raw materials market. Minmetals had attempted to buy Noranda, Canada’s largest mining company back in 2004, but the deal stalled.

In June, the Aluminum Corporation of China (Chalco), China's largest diversified metals and mining company, bought a 91% stakeVancouver-based Peru Copper for RMB 6.5 billion (USD 860 million). In an interview with the Financial Times, Chalco's president Qiao Yaqing described the deal as "an important step in our strategic growth outside China," adding, "We look forward to identifying further investment opportunities in Peru and around the world." Chalco also recently bought a 49% stake in Yunnan Copper in order to expand the latter's international holdings.

Chinese firms have also been active in the African mining market. In November last year, the China Nonferrous Metal Mining Group (CNMC) signed an agreement with the Zambian government to launch a 150,000-ton crude copper project around its existing Chambishi Copper Mine. Scheduled to start up immediately and be completed at the end of next year, the project will convert crude copper to concentrated copper at an investment of around USD 220 million. CNMC also signed a memorandum of understanding with three Zambian mining enterprises in May to mine seven copper-cobalt deposits in northwest Zambia.

Huayou Cobalt Nickel Material Co, a leading private cobalt chemical producer based in Zhejiang province, has also been licensed by the Democratic Republic of Congo's Gecamines to prospect 20 deposits in a copper-cobalt belt situated on the border with Zambia. Substantial exploration is scheduled to start within the next 18 months.

Allan Trench believes that Chinese copper firms will become increasingly active in global raw material sourcing in the coming years. "Globally there is an excess of smelting capacity and a dearth of concentrate," he said. "This won't change in the short-term, so Chinese smelting companies need to make strategic decisions now about concentrate sourcing in future years from various parts of the globe − the smart ones already are doing so."

Trench says a "strategic" approach won't mean vying with companies like BHP Billiton—the world's largest mining firm—in size. "[They] will make strategic overseas investments that act to strengthen their business," says Trench. "Chinese smelters investing in overseas copper mines to secure concentrate supply is an obvious first step for many."

William Adams, copper analyst at Base Metals in London, thinks a larger, state-backed deal could be on the cards. "China has the state reserves to do it, and with their new sovereign wealth fund [State Investment Corporation] it is more than likely they will consider buying a mining company," he said.

ACQUISITIONS Ahead

With global copper prices soaring, however, Chinese firms are far from alone in their quest to forge mergers and acquisitions. The bullish metals market has sparked a frenzy of consolidation activity, as overcapitalized producers seek ways to use their newfound wealth. Soaring infrastructure costs have meant that in many cases M&As are far more alluring than prospecting, building and developing new mines.

Last October, Brazilian mining company CVRD (Companhia Vale do Rio Doce), a key supplier of copper, iron and other metals to the Chinese market, purchased a majority USD 13.3 billion stake in Canadian mining company Inco, beating out a rival bid from Teck Cominco, another Canadian mining concern. With Brazil's biggest ever purchase, CVRD became the world's second-largest mining company after Australia's BHP Billiton.

Swiss mining company Xstrata became the world's fourth-largest copper producer after buying Canada's Falconbridge for USD 17 billion last year, and is currently studying two Peruvian copper deposits with combined resources of a billion tons.
In July, the mining sector's biggest-ever deal, the USD 44 billion takeover of Canadian Alcan by Anglo-Australian Rio Tinto, received the green light from the Alcan board. Rio Tinto successfully outmaneuvered Alcoa of the US, which had earlier bid USD 33 billion. Rio Tinto chief executive Tom Albanese explained that the takeover would position the company to take advantage of a booming Chinese economy that was demanding more copper, steel and aluminum every year.

"High takeover activity has come about for a number of reasons," said Base Metals' Adams. "Firstly, the demand outlook is strong. Secondly, it is easier, quicker and cheaper for mining companies to expand by taking over other companies with proven ore reserves. Thirdly, mining companies are flush with cash, and to expand through exploration and development would take too long. Fourthly, if western mining companies don't buy other mining concerns, the Chinese may buy them."

Phototgraph by: Chinafotopress

SCRAMBLING FOR SUPPLIES

Not all companies are relying on consolidation tactics to generate increased copper-related income. Vancouver-based Ivanhoe Mines is spending USD 1.5 billion to develop a huge four-mile long ore deposit in Mongolia, conveniently located near the border with China. The Oyu Tolgoi mining complex will eventually produce 450,000 tons of copper annually – or about 4% of total global output, according to Ivanhoe.

Currently Ivanhoe only produces a small amount of ore from its other mine sites. However, last October, Rio Tinto gave its Mongolian project a show of support by agreeing to take a significant stake in the Canadian firm. The world's second-largest mining group said recently it would increase its 9.9% stake once the Mongolian government gives final approval to the Oyu Tolgoi venture. The project could have a big impact on the industry. In June last year, Jiangxi Copper signed a letter of intent with Ivanhoe to study the possibility of taking a stake in the massive Mongolian project.

Yet China's demand for copper is such that some analysts fear that even huge projects like Oyu Tolgoi may not be enough to meet demand. "Copper prices will not be affected materially if the [Oyu Tolgoi] project comes onstream – even at full capacity – provided the dynamics stay the way they are," says CRU's Allan Trench. "The world needs more than one Oyu Tolgoi each year to keep pace with current consumption growth."

Producers from Chile to Indonesia have been racing to bring new copper streams online, but many larger companies say that output is already at an unprecedented level. Juan Eduardo Herrera, senior vice-president for strategy and business development at Codelco, admitted to BusinessWeek last year that the mining firm was "very stretched," adding that its plants were running at "110% of capacity."

London Money Exchange copper stockpiles, usually seen as a last resort if copper supplies are low, have recovered somewhat over the past few months but are still extremely low, falling from around 900,000 tons in 2002 to 120,550 tons on August 17. Australian investment bank Macquarie Bank forecasts that production of copper will continue to outpace consumption by 113,000 tons this year and by 82,000 tons in 2008. Nevertheless, the supply-demand balance remains precarious.

In addition to supply concerns, copper mines have proven to be particularly vulnerable to unplanned disruptions in recent months. Strikes, accidents, technical difficulties, planning constraints, political risk and shortages of skilled personnel, equipment and other supplies have all hampered the timely start-up of new projects and the smooth operation of existing ones. With the industry still stretched, more supply disruptions are likely, and low stockpiles will heighten the market's sensitivity.

CONTINUED PRICE GROWTH

Despite the slowdown in the US real estate market and the fallout of the sub-prime mortgage mess that could slacken demand, most analysts are predicting high copper prices through the end of 2008.

Macquarie Bank, Australia's largest investment bank, recently raised its 2008 copper price forecast to USD 3.50 per pound next year, compared with a USD 3.31 forecast for this year, while Citibank raised its three-year copper forecast from its previous USD 2.4 estimate to USD 3. London-based investment bank Barclays Capital has also raised its outlook for spot copper prices in the fourth quarter of 2007, based on expectations of robust demand from China.

This final point is key. Whatever the global supply of copper, there is one constant that's unlikely to change over the next few years. As skyscrapers soar, new power stations come online and phone and internet networks link the nation, China's copper need will continue to pick up. What remains to be seen is how producers, purveyors and processors of red gold will manage to keep up.