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After Xstrata, a Mining Merger Pileup

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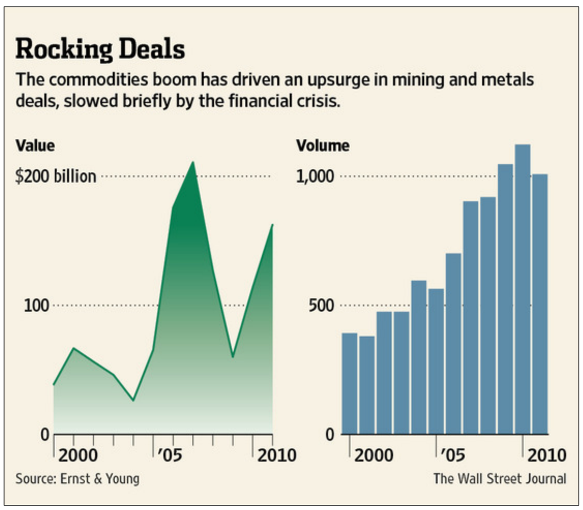
The proposed merger of Glencore International AG and Xstrata PLC would create a true rival to global mining heavyweights like Vale SA, Rio Tinto and BHP Billiton, as well as put pressure on midsize players to either team up or grow through acquisitions.



At stake: resources like coal, copper and iron ore that are crucial to a booming Asia. The world's top four coal importers - Japan, China, South Korea and Taiwan - took in more than $80 billion in coal alone last year, for example.

A merger of Glencore and Xstrata would create a true rival to global mining heavyweights and put pressure on midsize players to team up or grow through acquisitions. John Miller reports on Markets Hub.

Expect a Glencore-Xstrata merger to fuel two types of deals. "There's going to be the megamergers, which will pull levels of concentration much higher," says Michael Locker, the president of consulting firm Locker Associates Inc. Also, he says, companies will bet more heavily on smaller, riskier "frontier assets" in developing countries such as Zambia, Mozambique and Mongolia.

The potential Glencore-Xstrata combination would come during what already is a golden age for mergers and acquisitions in mining and metals - albeit one slowed by recent economic and financial turmoil. The number of deals in the sector rose to 1,008 last year from 564 in 2005 and 392 in 2000, according to a survey to be released Monday by Ernst & Young.

"We've been in a merger binge since the commodity boom started," says David Lipschitz, an analyst for CLSA/Crédit Agricole. Prices for commodities including coal and nickel took off in the early 2000s, propelled by the admission of China into the World Trade Organization.

And M&A conditions in mining remain ripe world-wide, analysts say. Commodity prices are high, while stock prices and borrowing costs are still relatively low. A record $84 billion in corporate bonds were issued by mining and metals companies last year, up 16% from the year earlier, while bank loans rose 2% to $187 billion, according to Ernst & Young.

A Glencore-Xstrata merger would add a catalyst. Combined, the company would have a market value of roughly $80 billion. But more important, the new company would have clout in several areas. It would control one-third of the market for thermal coal used to generate electricity and become the world's largest producer of zinc, with 15% of overall production. The new company also would vie with midsize Freeport-McMoRan Copper & Gold Inc. for the title of the world's second-biggest copper producer, behind state-owned Codelco of Chile.

As fears of a global financial and economic meltdown recedes, megamergers among top 10 players—possibly even a renewed effort by BHP to acquire Rio Tinto—are more likely, industry bankers and analysts say. The Anglo-Australian miners and Brazil's Vale together control 70% of the world's seaborne iron-ore trade.

That said, there is no guarantee that Glencore and Xstrata will succeed in merging, even if, as expected, they announce an agreement when Xstrata reports results Tuesday. For one, antitrust regulators have blocked deals they consider anticompetitive and there is no indication that regulators will stand down.

Also, shareholders have set a high bar. The kind of deal that Xstrata and Glencore are discussing—a merger of equals that people familiar with the matter say would include at most a modest premium for Xstrata shareholders—is a type that many investors have been unwilling to support. In 2009, a year after BHP failed in its attempt to acquire Rio Tinto, Xstrata tried to buy Anglo American PLC, a midsize Anglo-South African conglomerate. That deal fell apart after Anglo American shareholders balked.

Any of those deals could resurface, analysts say. Freeport also would be a juicy takeover target, but its market value of $44 billion would make such a purchase an expensive proposition.

The other type of hot deal represents a hunt for resources in frontier nations such as Zambia, Mozambique and Mongolia, with valuable deposits buried under remote, unforgiving landscapes. There were 87 frontier deals last year, valued at $20.2 billion in total, and three-quarters of them involved those three countries.

Among them, Canada-based Barrick Gold Corp. paid $7.4 billion for Equinox Minerals Ltd., the main asset of which was Zambian copper mines. And Rio Tinto paid $3.9 billion for Riversdale Mining Ltd., which controlled one of the world's biggest untapped coking-coal deposits, in Mozambique.

Last month, Rio increased its stake in Ivanhoe Mines Ltd. The Canadian company's main asset is Mongolia's Oyu Tolgoi mine, which is set to become the world's biggest copper mine when it begins production next year. Between 15 and 20 mines a year are going into operation in Mongolia. The country last year passed Australia as China's main supplier of coking coal, which is used to make steel.

Frontier investments are risky, however.

"You build a mine in Guinea: You don't know if you'll still have it in five years," says Mr. Locker, the consultant. As another example, he cites Rio Tinto spending $1 billion to build a rail line in Mozambique. "And you can't take it with you when you leave."