

BHP-Rio merger

BHP and RIO Tinto are two of the world's biggest mining companies and have benefitted hugely from China's economic growth. With growth rates in China of up to 10 per cent per year, the need for raw commodities to industrialize China has been immense. Vast amounts of steel, copper, coal and other materials have flowed into China in recent years and the suppliers have been the big mining companies such as BHP and RIO.

It has now dawned on the mining companies that combining forces may have some merit. BHP the Anglo-Australian miner recently offered US\$150 billion in shares for its rival RIO Tinto. The offer was rejected.

But this is more like playing hard to get than a straight out refusal to merge. The logic for the two to tie up is strong. Following a process of analysis and review, BHP has identified synergies of US\$3.7 billion a year from a merged unit of BHP and RIO. This would suggest a net present value of US\$26 billion, or 7 per cent of their combined market value.

In fact the benefits could be much higher. The big reason for merging is the increased negotiating strength the combined group would have with its big Asian and Chinese clients. BHP has clearly worked on the likely value of this strategic strength, but has not gone public for fear of publicly upsetting its key customer groups.

So the deal is likely to happen, but the bigger question is how? BHP's three for one share offer values RIO at US\$150 billion and would give BHP 44 per cent of the combined group. RIO can probably ask for a better deal, giving a larger slice of the combined company. This is because much of the value identified by the deal can be found by unlocking the capacity that RIO has in Western Australia.

By raising the productivity of RIO's Australian assets and channelling more of that output to China through some of BHP's contacts, the financial results should be impressive. However, RIO should be cautious about asking for cash. By taking shares, RIO's shareholders will also benefit from any uplift in the value of the company which stem from realised synergies. Of course they will also take the loss if the numbers being relied upon by BHP are overly optimistic.

Questions

1. Explain what is meant by the term net present value.
2. Explain how BHP will have attempted to arrive at an estimated net present value of US\$26 billion.
3. Based on the benefits of previous mergers, if you were a RIO shareholder, would you take shares or cash as part of the merger deal?