

Mining for M&A nuggets in the basic resources sector

By Juergen Trojan*

Five years ago, I was working as an analyst for Deka Investment Management. I decided to take a position in a company called Arbed, a producer of steel, iron and related products. It was trading at just two times earnings and had good prospects for growth. The same was true for another firm, Salzgitter, a manufacturer of steel and associated goods. Despite the give-away valuation, the recommendation found only scepticism. Why? The sector was out of favour at the time.

But this story had a happy ending. The stocks went up nicely and they really took off when the merger and acquisition (M&A) wave finally hit the basic resources sector.

How times have changed. We have seen an upsurge in takeover activity in the mining, oil and steel sectors and that has helped this area of the market to be one of the best performers in the past year. Now the question is, are there any attractive takeover candidates left for the prudent investor?

I'm afraid to say the easy gains are probably behind us. However, all is not lost as there are definitely some unpolished gems still out there.

A tug of war

I think a great example is the Gold Fields bid for Western Areas.

The logic seems obvious. The main asset of Western Areas is the Southern Deep Deposit, the biggest deposit in South Africa. However, it's also South Africa's

deepest mine and therefore mining there is technically complex. Finally, the company was poorly managed and due to high investments and years of losses the balance sheet needs strengthening.

Adjacent mines are run by Gold Fields and Harmony – well known rivals as Harmony once made an unsuccessful offer for Gold Fields – and, interestingly, each of them own 20% stakes in Western Areas.

For various reasons, both companies need to grow their reserves and resources. It was no surprise to me that the more financially sound Gold Fields began the battle by acquiring the other half of Southern Deep from Barrick Gold and is now offering 35 of its own shares for 100 Western Areas shares.

I would not be surprised if we saw an increase in the offer or if Harmony entered the battle.

The worst case scenario is that Western Areas' management claims

the offer is too low and Gold Fields withdraws the bid. Taking into consideration how deeply Gold Fields is engaged in Southern Deep, this outcome is unlikely. If my analysis is correct, there's a good chance that the management asks

for an increase in the offer by, say, 10%, and the offer is accepted.

A very big deal

Interesting rumours surfaced recently that Anglo American, the world's second-biggest mining company, could be broken up if a rival such as Rio Tinto or Xstrata bought the company. I'm not sure these specific rumours deserve merit. However, they reminded me that we have to consider Anglo American as an eventual takeover target. In the current investment environment, I can see a scenario in which Anglo American's shares appreciate, as the company's outlook remains fundamentally sound.

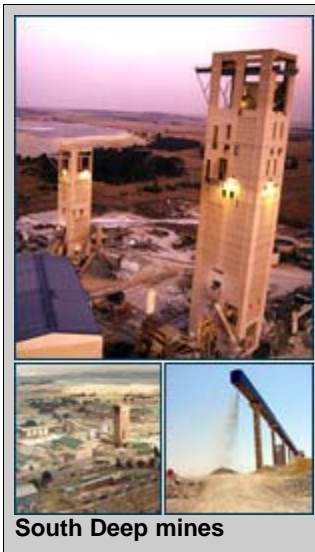
A platinum-plated opportunity

I also think Impala, the South African platinum producer, is a good takeover candidate. The shares are widely held with few big shareholders. The main problem is that due to anti-trust constraints, only a non-platinum producer will be able to acquire the company.

Interestingly, the price of its shares does not reflect the hypothesis of a takeover. Some observers argue that with a price/earnings multiple of 20, the firm is not cheap. However, I believe that Impala's earnings should improve in 2007 in proportion to the decline of the South African rand.

All in all, if commodities benefit from another bullish leg, the sector should enjoy another wave of takeovers. Until then, though, we will keep digging for the few opportunities that are left.

*Juergen Trojan, advisory, member of DVFA



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