Show us the money

China's investment in African resources is gaining pace

BY ANTHONY DESIR

THE latest developments in North Africa and the Arabian Gulf provide an insight to China's resource acquisitions plans and its likely strategic adjustments for future investment in African mineral projects.

Significantly, investment data clearly shows that the anecdotal stories about China not favouring Africa with its investment dollars simply do not add up.

China's overall large-scale (over US$100 million) non-bond investments from 2005 to December 2010 have flowed principally to the western hemisphere (US$89.8 billion to North America), excluding Europe.

However, the big surprise is that China's regional investment in Sub-Saharan Africa (US$43.7 billion) is on par with its commitment to west Asia (US$45.2 billion) and is more significant than its investments in Australia (US$34.4 billion) or Europe (US$34.8 billion).

China's Arab states investments totalled US$37.1 billion, and centre around energy projects and related infrastructure – it is no different in Africa.

These figures, from research and analysis group The Heritage Foundation, are based on very conservative tallies of the larger projects (*see bar chart, right*).

When smaller investments (less than US$100 million) are factored in, the overall numbers are greater. The investment patterns, however, remain roughly the same.

Resource experts tracking the China-Africa relationship and undervaluing the lessons of China's energy investment strategies, miss the point completely.

Africa is China's largest oil supplier and countries such as Nigeria and Angola owe their recent economic growth and development principally to China's capital support for these industries.

Every argument about China's failure to support resource development in Africa falls flat when the subject turns to energy. At the same time these same arguments are convincing in just about all other resource industries.

Why is China willing to back African energy investments, but seems less keen on backing other mineral industries?

The answer may lie in China's method of investing and in Africa's still maturing process of development (although some believe this process is about to change dramatically).

GOVERNMENT TO GOVERNMENT

China prefers to deal on a state-to-state level, with its big state-owned companies as its muscle. This, more than anything, paints the picture of China's investment strategy in Africa.

The basic China-Africa policy is directed through China's Ministry of Foreign Commerce, and implemented by a quasi-government agency known as the Forum for China Africa Cooperation (FOCAC), which convenes as a meeting of state leaders from Africa and China every two years.

During the off-years, when FOCAC is not gearing up for its major heads of state hob knobbing, the Chinese side continues to set policy and co-ordinate a central strategy with an entire office complex in Beijing developed just for this purpose.

China retains a significant negotiating advantage over all African states by using its state agencies, embassies and consulates as its eyes and ears, while taking commercial direction from its central planners and executing through state-owned agencies.

There is no such cohesive or centralised effort on the African side, allowing China effectively to play one country against the next by waving the carrot of appearing to consider backing investment schemes. China's historic investment pattern, however, shows that dollars have been overwhelmingly directed to resource buying, and principally to what are seen as China's strategic needs.

On an analytical level, the Chinese have shown themselves to be impressive traders when negotiating buying and selling prices at all levels, and have used their buying power and capital muscle to great effect.

They have been less impressive in private-sector deal making and finance arenas where nuance and creativity close deals.

China's trading skills work well in less developed markets where power plays can impress government figures hungry for a big public announcement. However, they tend to be less successful in more complex commercial processes where market forces are in play.

The Chinese side remains instinctively uncomfortable with any event that ends in a change in government because their business dealings are very much focused on personal relationships.

When the parties with whom they have developed close working relationships leave power, the deals in the works also evaporate.

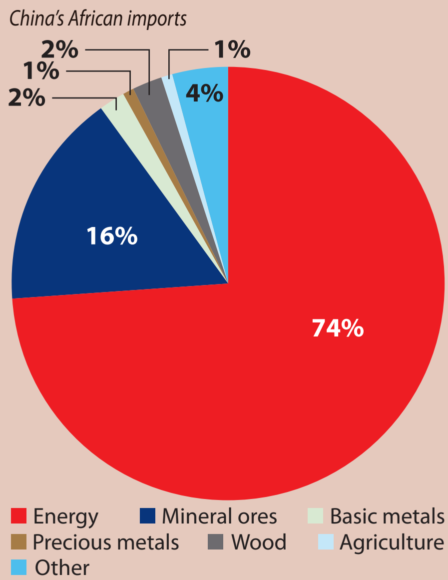
Some Chinese commentators view an election with the same disdain they hold for a political coup because, from the Chinese perspective, a change in leadership usually means cultivating new ties no matter what process brought about the change at the top.

Despite these frustrations, China continues to show a preference for dealing with government figures rather than private business partners. A quick comparison with Australia helps to show the problem more clearly.

Australia is China's largest mineral-investment destination. During the global financial crisis of 2009, Chinese planners opened their wallets and directed their state enterprises to go on an acquisitions spree, beginning with Australia. The effort backfired with the tie up in Oz Minerals being reorganised and the acquisition of Rio Tinto being scuttled.

China was genuinely shocked at the adverse reaction to its investment overtures, which other regions had been begging to accept. The difference, of course, was

CHINA'S AFRICA INVESTMENT



RAPID RESPONSE

China's scramble to evacuate 36,000 workers from Libya during the early weeks of the political crisis early this year was hailed in the mainland press as a triumphant 'coming of age' logistics success.

The extraction of so many contract workers from one country and the looming write-down of billions of dollars in strategic investments are less of a headache for China than the subsequent jump in oil prices.

According to reports from the Chinese press, China's commerce minister Chen Deming confirmed that 29 Chinese companies had signed 50 construction projects in Libya worth a total of US$18.8 billion. Estimates are that Libya supplied 3% of its oil exports to China and the loss of reliable long-term supplies is a greater concern to China than the capital losses.

China is the world's second-largest oil consumer at around 9,600Mbbl of oil per day, with imports of about 60% of that amount, according to figures from the US Energy Information Administration.

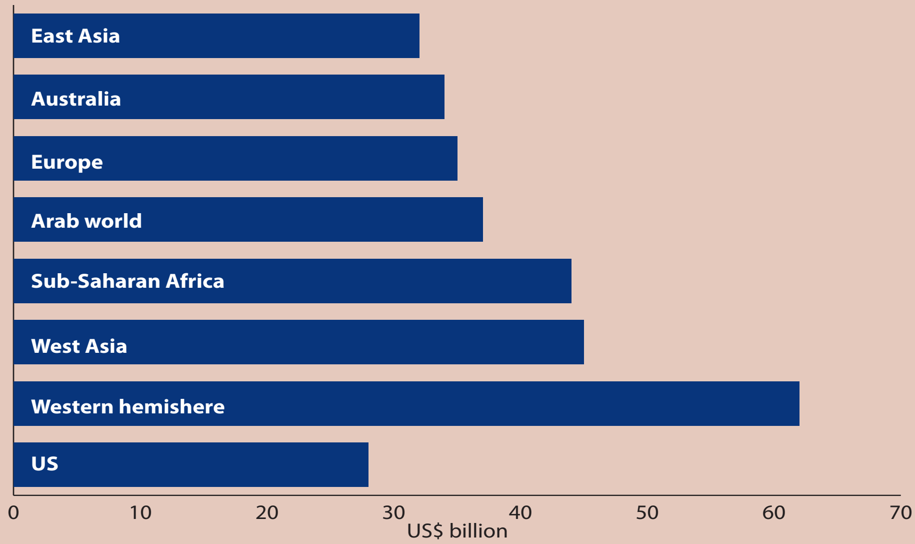
In capital terms, China loses more hard currency by having to pay higher prices for oil, than through its direct write downs of project investments.

These investments are made strategically to help secure long-term supplies, with China's central bank offering its huge foreign reserves as the capital account for to its SOEs to buy up targeted acquisitions.

Given China's need for resources, the challenge of getting back in the game and getting these supplies are the bigger issue. China's response to the situation is a good indicator of its overall resource acquisition strategy in Africa and elsewhere.

Photo: Bloomberg News

China global non-bond investment over US$100 million (2005-2010)



that when capital markets stabilised Australian companies had a choice of where to find funding and on better terms. Chinese investors were frustrated by the commercial process and even more irritated when the Australian government seemed to take a position favouring local interests and making Chinese investment more difficult.

What surprised many of those looking at the power dynamics was how slowly the Chinese responded to market changes, and how their otherwise capable investment directors were unable to respond with creative commercial strategies.

Its experience in Australia was both irritating and instructive to China.

The country's failed investment overtures have gone a long way to helping the Chinese grudgingly accept that commercial reality and private enterprise, while not independent of political interference, can co-exist with political upheavals.

The financial adjustment on the Chinese side has been to focus less on targeting listed acquisitions and shift to earlier stage investments at the near or pre-IPO level.

This important commercial change has seen a jump in Chinese investment in Australia even after its newsworthy stumbles, but the change will only be apparent when these investments mature in years to come.

The new method also gives Chinese planners a practical model that will increase their confidence in less mature markets where they are being asked to consider more commercial and private deals, rather than government-sponsored initiatives.

COMMERCIAL EVOLUTION

The African side of the equation is made up of 56 counties (57 when you count the most newly formed Southern Sudan) with varying degrees of political maturity and development.

China's planners do not appear to be sceptical about doing business with states that are unstable. In fact, they seem to prefer dealing with governments that offer better state-to-state incentives than in areas where the commercial process is more mature.

The evidence of this is the same across a broad range of commodity purchases.

In the mineral sector, the Democratic Republic of the Congo (DRC) has attracted over US$4 billion in mineral investment over the past five years, while the South African resource sector has attracted less than US$200 million over the same period.

The argument that there are more investment opportunities and less commercial risk in the DRC than in South Africa, Mozambique or Botswana is unconvincing. The key difference is that China can operate more comfortably in places with far less scrutiny, oversight and political opposition.

The pattern also illustrates an appetite for risk that is often not admitted to, even by the Chinese.

China is willing to take significant investment and commercial gambles when it is dealing on a state-to-state level, but it less comfortable with even basic commercial risk outside the sponsorship and direction of a foreign government party.

Africa's attraction as investment destination has changed in past ten years as a result of interest from China. Cross trade jumped from US$10.9 billion in 2000 to more than US$150 billion in 2010. China's investment in Africa is expected to grow by 60% by 2015.

Outward investment by Chinese firms has only started to ramp up in the past five years. In January, the Ministry of Commerce reported that total overseas investment by Chinese companies in non-financial sectors was US$59 billion last year.

China's co-owned largest investment in Africa, Standard Bank, forecasts China-Africa bilateral trade to double in four years to US$300 billion from US$150 billion last year. Over the past 15 years, China-Africa trade has doubled every three years, the bank says.

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The bank also predicts that Africa's GDP is likely to double from US$1,500 billion today to about US$3,000 billion in 2015.

"Trade and investment routes into Africa are being recalibrated as economic momentum shifts to the east," says George Fang, head of mining and metals, China. "Through trade and direct investment, China is broadening its resources supply base with Africa as one of its key partners."

Energy markets have so far been the key beneficiaries of China's entry into Africa, but there is an emerging trend of African states (even among the energy markets) demanding more from their benefactors.

The Sino-African investment relationship is rapidly evolving from its chaotic infancy, characterised by misunderstanding on both sides.

Chinese insensitivity to African political and economic issues was a sign of its belief that government-to-government payments for African resources were enough to make it a welcome presence.

African frustration with China's reluctance to localise, transfer technology and operate in the private sector has led to resentment and rumblings across the continent.

Opposition political voices and local landowners who did not reap the benefits of China's spending spree have been getting a louder.

The 2008 market turnaround caused a slowdown in China's headlong rush into Africa but this led to a more sober view of the relationship from both sides, and an adjustment in the African view of China that the latter has not yet come to terms with.

Key issues that have driven the relationship have been Africa's need for investment and China's need for resources. But the initial marriage of these needs was an

imbalanced one, where China called the shots and entrenched politicians in Africa were the principal beneficiaries – either directly or through political manipulation.

The financial crisis of 2008 and 2009 was the unexpected wake up call for most of Africa, when China effectively turned its eyes away from the continent in the hopes of poaching big resource deals in developed markets.

Oil producing states saw little change in China's interest, because in reality China could go nowhere else, but the mineral sector reported that Chinese investors virtually disappeared, along with everyone else.

Governments and private businessmen that had pinned their hopes on Sino investments have become more sceptical that China is an open cheque book and have started looking to move down the value chain by asking for more than the purchase agreements waved about by large Chinese buyers.

The more forward looking planners from across Africa are demanding more local ownership in the form of economic enterprise equity (such as the BEE type programmes in South Africa, Zimbabwe and Botswana).

This change is being manifested in a shift to promoting industrial development projects and refinery capacity, as well as promoting deals for infrastructure projects that support industrial development (the latter particularly in north and central Africa).

This 'maturity' is seen as a major step forward from the initial stage of the China-Africa relationship which was very much focused on the buying and selling of commodities and short-term goals on both sides.

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THE FUTURE

The future Chinese approach to investing in Africa is difficult to scrutinise because China's strategy is tightly controlled and only obvious after the fact. But the general evidence of China's intention can be gleamed from its overall patterns of behaviour both inside and outside of Africa.

China is expected to aggressively increase its investments in Africa in all areas.

At the peak of the Arab states crisis, China's foreign minister Yang Jeichi confirmed, during the National People's Congress, that China intended to take a more confident investment position in Africa even as political changes loom.

This statement alone would be seen as political rhetoric, but the real peek at China's intentions came months earlier during the revelations of China's 12th five-year plan announced in late 2010.

As part of the new plan, the government introduced a substantial easing of restrictions on Chinese foreign direct-investment companies (OFDI) that are given official permission to operate outside of China. These pioneering enterprises make decisions in different ways and much faster than China's state-owned enterprises (SOEs).

OFDIs are better suited to address the needs of the resource sector, where smaller initial investments are needed more than large later-stage funding.

Photo: Bloomberg News

Photo: Bloomberg News

CHINESE SOES FOLLOW PIONEER INVESTORS IN AFRICA

China's resource appetite has few limits, and its state-owned companies (SOEs) are willing to buy just about any proven asset either by off-take agreements or open-market trading.

The difficulty for the Chinese is that their off-take arrangements come at the later stages in the mining process and mostly at premium prices. Nonetheless, they have been reluctant to invest at an earlier stage because of difficulties assessing and assuming risk, but are wiling to pay much more for the same assets once another investor has cleaned up the project.

Pioneering companies that have marketing relationships with the Chinese buyers take advantage of this arbitrage by making early-stage investments and then become comfortable brokers who act for, or sell to, the Chinese.

This is exactly the role that Chinese OFDI will be expected to play when it takes the investment lead and becomes the bridge between the SOEs and the project owners, who liquidate at later stages.

There are several examples of the process working in Australia, for example, but a more recent project in Africa also illustrates the same model.

Kalahari Minerals plc is an AIM-listed African mining company with a significant stake in Extract Resources Ltd, owner of the rights to the Rossing South uranium mine in Namibia.

China's need for uranium is well established in policy statements as is a much reported plan to build a new city the size of Hong Kong every year for the next 20 years.

Despite the obvious attraction of the large reserves and the potential sizable off-take, Kalahari was unable to secure the investment interest of China's big SOEs until a China-related intermediary took the lead.

Hong Kong-listed natural resource investment and commodity trading company APAC Resources Ltd stepped into the opportunity.

Although APAC is not a Chinese OFDI, its global investments are China related so its principals in Hong Kong were well aware of China's needs, the uranium supply deficit and the value Kalahari represented.

APAC invested £29.6 million (US$47.7 million), which gave the mining company the working capital it needed to help tidy up the project.

Within a year, shares in Extract Resources jumped on expectations it could become a target for Rio Tinto after a Chinese bid approach to the uranium miner's leading shareholder, Kalahari.

The US$1.23 billion takeover offer recently from a unit of China Guangdong Nuclear Power Holding Corp (CGNPC) came into focus following the leading investment and marketing from APAC.

There is no question that CGNPC could have acquired these same assets and others for much less, leaving a question over what prevents this major SOE from making these ground-breaking initial investments.

From China's point of view, it has ownership of the uranium project even if its initial investor happens to be a private Chinese company, and not a state-owned enterprise.

China's SOEs are able to tap into the state's vast financial reserves and do not measure their costs of funds in real commercial terms. The problem with this model is that it encourages SOEs to overplay risk and to overspend on assets whenever they acquire an attractive project outside of their state-to-state investment focus.

Africa's producers and project managers do much better by looking for smaller companies with a China presence than chasing after the big companies that make the news with their later stage buyouts.

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Photo: Bloomberg News

Smaller Chinese companies, both government owned and private, are the ones that will be making the investments of less than US$100 million that will fuel growth of the resource sector in Africa.

According to Chen Lin of China's Ministry of Foreign Commerce, China expects about 70% of its African investments to be eventually directed by private companies.

China's positive experience in the African energy sector and its change in focus to earlier stage resource investments in Australia are two specific developments that will make it easier for Chinese companies to overcome their doubts about doing deals in Africa.

Large state-owned companies will continue to chase government-to-government deals, but the exciting story should be smaller Chinese companies willing to cut deals at earlier stages of the investment process and for smaller sums.

That is the private capital base that Africa has still not found and these smaller, early-stage investments will fuel the resource development boon in Africa.

> "China is expected to aggressively increase its investments in Africa in all areas"

Historically, the African mining industry has been about selling ore, with much less emphasis on refining capabilities. In many cases African mineral concentrate has been priced out of the market after factoring shipping cost.

The formula works well for some products but as the South African chrome industry has shown, when state supports shifts to promoting investment in refineries and smelters, the value proposition changes dramatically.

The combination of African economic empowerment programmes and the coming wave of Chinese investment will shift deal-flow from selling minerals to promoting co-investment opportunities as a conduit to offtake.

The African sellers will benefit more by getting better equity deals and moving closer to refining and production, especially in places where political stability allows all parties to focus on long-term goals.

About 10% of China's offshore investment dollars are presently spent in Africa, although much of China's noise about 'investing' in Africa has been nothing more than announcements about mineral purchases and off-take deals.

A different relationship is on the horizon, however, as the type of Chinese companies doing business in Africa changes and African hosts demand better beneficiation through equity set asides and localisation.

Competition at this level from other parities, including Indian investors, will allow African partners to step up from the 'take it or leave it' terms that had characterised its relationship with investors in the past.

Anthony Desir is principal of Strategic African Minerals Investment (SAMI Funds).