Global Counsel

China's part in Tom Albanese's downfall

22 January 2013

Summary

Tom Albanese's departure from Rio Tinto last week was precipitated by substantial write downs in Rio Tinto's aluminium businesses. Rather than just a case of a badly-timed bet on the global market for aluminium, this is the result of a bigger shift in aluminium markets. It is a structural shift in which speculative investors and Chinese state capitalism play a key role.

Why is it hard to make money in aluminium? Tom Albanese's departure from Rio Tinto last week was precipitated by the write-down of $10-11bn in Rio Tinto's aluminium assets, the bulk of which sit in Rio Alcan, the Canadian aluminium smelter bought by Albanese's predecessor in 2007. The $2800m/t aluminium price that made the Alcan deal look sweet in 2007 has been replaced by a global downturn and four years in which LME aluminium prices have not risen much above $2200m/t, languishing at around $1900m/t. Much of the coverage of the changes at Rio Tinto has put this down to a question of bad executive timing.

To be sure, Alcan was bought at the top of the market. The more interesting question here is whether the collapse in metal prices that has made it look overpriced is cyclical or structural. Projected demand for aluminium as the global economy recovers is strong. But so is capacity. Inside the aluminium industry the big question is what is producing the glut of metal that drove down the global prices that ended Mr Albanese's time at the top of Rio Tinto. There are a number of plausible answers.

First, as they have with copper, the dramatic growth of physical commodity index funds for aluminium, fuelled in turn by a huge amount of liquidity created by quantitative easing, have created a big new market for aluminium that sits between producers and manufacturers and effectively keeps metal off the market, compounded by investments in warehousing by traders. Estimates of the scale of this off-market metal vary, but there is probably around 12bn tonnes of aluminium held off market in LME and non-LME warehouses at the start of 2013, with another million tonnes in Chinese warehouses. There are about 70tonnes of aluminium in a Boeing 747.

This suggests an aluminium market that may work in future more like the market for gold – in which industrial users share the market with buyers who hold the metal speculatively, and in which projecting prices is commensurately harder, and more inherently linked to market sentiment than just industrial demand. This demand from funds has created a market for the metal that is disconnected from final demand, and acts as an incentive for overproduction.

The China factor

But the other elephant in the room in terms of the market's price signals is China. China's strategic commitment to aluminium production to feed its manufacturing industries is a key part of the political economy of aluminium. China is the world's largest single user of the metal, consuming around 45% of total global production. The Chinese 12th Five Year Plan in 2011 made self-sufficiency in meeting this demand an explicit goal.

Global Counsel

With implicit and explicit political backing, China's aluminium industry has continued to raise production steadily since 2008, despite stalling global demand. Where every other producer in the global economy has reduced production, China has continued to raise it (Fig 1). Although China is shutting down older smelters, it is also building new capacity in Xinjiang, closer to China's large coal resources, which provide the electricity for the energy-intensive smelting. Even where capacity has been idled in key provinces such as Henan over 2011 or early 2012, these suspensions have often proved short-lived.

The net result is that China is building and using capacity considerably faster than it is taking capacity out of the system. Official Chinese data, which probably understate the scale of production, suggested that China produced around 18million tonnes of primary aluminium in the first 11 months of 2012, up more than 12% on a year earlier.

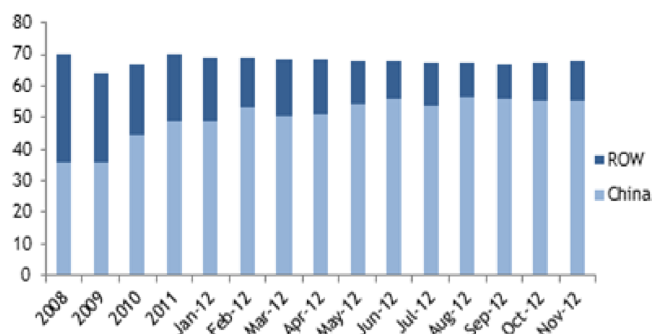

Fig 1: Global aluminium production 2008-2012

Source: World Al 2013

The most perverse and predictable effect of this overcapacity and overproduction is a fall in Shanghai SHFE prices (and ultimately their LME equivalents, which track SHFE prices closely) that means that perhaps half of Chinese aluminium production is unprofitable at the start of 2013. For reasons of prestige and local employment, these zombie smelters are kept alive by a combination of local government subsidy, energy tariff discounts and creditor forbearance - and there is often a very blurred line between the three things. Aluminium smelting accounts for at least a fifth of all energy use in the top five aluminium producing states in China: Qinghai, Henan, Gansu, Inner Mongolia and Shandong. So energy producers also have a strong incentive to lobby against idling capacity and to discount energy accordingly.

Any appearance of self-sufficiency that this creates is also largely illusory. China has not been self-sufficient in the key primary component of aluminium, bauxite ore, for almost a decade and it is also a large importer of alumina, which is used to make primary aluminium. Much of its ore it imports comes from markets like Indonesia, which is why it was so alarmed at the prospect of Jakarta imposing export tariffs on bauxite in 2012. With raw alumina accounting for around two fifths of the cost of smelted aluminium, this increase in base costs would have pushed its smelting industry even further into the red.

State capitalists and speculators

For producers outside of China the question is whether this state of affairs is likely to persist. By shielding Chinese producers from failure, or even from the sharp capacity cuts that producers in the US, Europe and Russia are undertaking to sustain profitability, the Chinese system is absorbing losses that are falling on private market players elsewhere. All the major global producers including Rusal, Rio Tinto, Alcoa and BHP Billiton have announced production cuts of between 6-8% of their total aluminium production since mid-2011 and called a halt to or scaled back large capital projects. Some of this closure, as at Alcoa's US smelters, is permanent. As in China, this will inevitably distort the shape of the industry that will remain after the current squeeze.

A number of non-Chinese producers have speculated that if China's demand runs ahead of its capacity to produce aluminium in a cost-effective way (given the cost of raw materials, energy and even transit from western China to the manufacturing hubs of the eastern seaboard) then China's growing demands for imported supply could help resolve some of the current oversupply dynamics. Of course, this is to take a gamble on Beijing's desire or ability to impose a rational solution on its sprawling state-backed industrial

Global Counsel

economy and its vested interests, and for the banking system to absorb the losses.

For now, public policymakers outside of China are likely to watch from the sidelines. But, as there has been in the solar panels sector (GCI: Why there will be no simple wins in the solar panel trade wars), there will eventually be pressure to look more closely at Chinese practice, especially if there is a perception that subsidised Chinese product is being dumped on western markets to the detriment of local producers. In the tense international debate over China's economic model, aluminium may yet become a point of wider tension.

This leaves the industry outside of China facing a set of serious questions. What happens if physical commodity positions in aluminium are unwound in a disorderly way? What are the long-term implications of a market in which large speculative players in the markets make spot pricing more volatile? Will China accept the inherent flaws in a policy of self-sufficiency and remove – as opposed to simply idle - capacity in a way that ultimately provides a new source of demand for western and Russian producers?

Between China and the Gulf states, where strategic state support and cheap energy has also supported expanding production even as the global industrial market contracts, the question facing the industry globally is how far state capitalist systems are prepared to go to expand what they see as a strategically important sector, at the expense of the global market and competitors. The only simple answer is that that the next decade looks like an unpredictable one for the aluminium sector.

None of this is to excuse a costly write-down at Rio. Alcan was priced for the top of the market, and the market has changed. But Tom Albanese has been navigating the business not just into economic and cyclical headwinds but a market significantly distorted by state capitalism and speculative behaviour. These debates have been rebounding inside the world of aluminium for months. In Mr Albanese they have claimed their highest profile casualty.

*To contact the author of this Global Counsel Insight please email **Stephen Adams** (s.adams@global-counsel.co.uk)*

Global Counsel

38 Wigmore Street
London
SW1U 2HA
info@global-counsel.co.uk
+44 (0)207 656 7600

© Global Counsel 2013

Although Global Counsel makes every attempt to obtain information from sources that we believe to be reliable; we do not guarantee its accuracy, completeness or fairness. Unless we have good reason not to do so, Global Counsel has assumed without independent verification, the accuracy of all information available from official public sources. No representation, warranty or undertaking, express or implied, is or will be given by Global Counsel or its members, employees and/or agents as to or in relation to the accuracy, completeness or reliability of the information contained herein (or otherwise provided by Global Counsel) or as to the reasonableness of any assumption contained herein. Forecasts contained herein (or otherwise provided by Global Counsel) are provisional and subject to change. Nothing contained herein (or otherwise provided by Global Counsel) is, or shall be relied upon as, a promise or representation as to the past or future. Any case studies and examples herein (or otherwise provided by Global Counsel) are intended for illustrative purposes only. This information discusses general industry or sector trends, general market activity and other broad economic, market or political conditions. It is not research or investment advice. This document has been prepared solely for informational purposes and is not to be construed as a solicitation, invitation or an offer by Global Counsel or any of its members, employees or agents to buy or sell any securities or related financial instruments. No investment, divestment or other financial decisions or actions should be based on the information contained herein (or otherwise provided by Global Counsel). Global Counsel is not liable for any action undertaken on the basis of the information contained herein. No part of this material may be reproduced without Global Counsel's consent.