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SZLN: ACQUIRING PEM

Xingyun Liu, Lifan Wu and Jim Hatch wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

As the financial crisis became more severe in early 2008, the prices of base metals, such as zinc and lead, declined greatly. As a result, many mining companies suffered significant operating losses and experienced extreme difficulty obtaining financing from the capital markets. Consequently, some companies had to either sell some of their assets or find a strategic buyer.

In late November 2008, Zhang Shuijian, the chief executive officer (CEO) of Shenzhen Zhongjin Lingnan Nonfemet Co. Ltd. (SZLN), and his management team had identified an opportunity to acquire Perilya Limited (PEM), a base metal mining company listed on the Australian Securities Exchange (ASX). Before making an offer, the team needed to determine the strategic benefits of this acquisition, the risks that might be incurred as a result of the purchase and the maximum price SZLN would be willing to pay.

ABOUT ZINC AND LEAD[1]

Zinc is the fourth most common metal in use, trailing only iron, aluminum and copper. About three-quarters of zinc used is consumed as metal, mainly as a coating to protect iron, steel and aluminum from corrosion. The resulting product is known as galvanized metal. Zinc is also frequently employed as an alloying metal to make bronze and brass, as a zinc-based die casting alloy and as rolled zinc. The remaining one-quarter of zinc is consumed as zinc compounds, mainly by the rubber, chemical, paint and agricultural industries. In 2008, global refined zinc production increased by 5.1 per cent to 11.9 million tons, and consumption by 3.8 per cent to 11.8 million tons. Metal production rose as a result of increased output in China and India. A decline in zinc consumption in Europe and the United States during the year was offset by increased consumption in countries with emerging markets, particularly China, but also Brazil and India. Identified zinc resources of the world were approximately 1.9 billion tons.

Lead is a very corrosion-resistant, dense and ductile metal, which has been in use for at least 5,000 years. Concern with lead poisoning has reduced the demand for lead in non-battery products. Use of lead worldwide was estimated to have increased by about 5 per cent in 2008, driven primarily by strong

[1] *U.S. Geological Survey, Mineral Commodities Survey, 2009, at http://minerals.usgs.gov/minerals/, accessed March 2010.*

economic growth in the information technology, telecommunications and transportation sectors in China. Global lead mine production in 2008 was expected to be 3.8 million tons. Identified lead resources of the world totaled more than 1.5 billion tons.

In recent years, significant lead resources were found to occur in areas with deposits of zinc, silver, and copper. As a result, lead ores were produced as a byproduct of mining these other metals. In fact, zinc producers typically netted lead revenues when calculating their zinc production cost.

SHENZHEN ZHONGJIN LINGNAN NONFEMET CO. LTD.

China Nonferrous Metal Industry Shenzhen Co., the predecessor of Shenzhen Zhongjin Lingnan Nonfemet Co. Ltd. (SZLN), was founded in 1992 and went through several restructurings, including a merger with Guangdong Shaoguan Lingnan Lead Zinc Group Ltd. Co. (Lingnan) in 1999. The major assets of Lingnan were the Fankou Lead Zinc Mine and the Shaoguan Smelter. At the time of the merger, Lingnan was China's largest lead zinc ore mining company and China's third largest lead zinc smelter. In January 1997, the company listed its stock on the Shenzhen Stock Exchange and, after the amalgamation, changed its name to Shenzhen Zhongjin Lingnan Nonfemet Co. Ltd. (SZLN). SZLN's largest shareholder (at 38.22 per cent) was Guangdong Rising Assets Management Co. Ltd., a state-owned enterprise. As of 1999, lead zinc products contributed approximately 80 per cent to profits, construction material and decoration 10 per cent and trading approximately 6 per cent.

Due to an economic downturn and continuously depressed demand for lead and zinc, the prices of lead and zinc fell to historical lows, resulting, in 2001, in a decline in SZLN's net income of more than 75 per cent compared with 2000. In response, the company formed a new management team with Zhang Shuijian as the new CEO. This team instituted stringent cost controls and restructured the business to make lead and zinc products the company's main focus. As a result of this restructuring, net income in 2002 increased by more than 30 per cent over the previous year, despite the low metal prices.

By the end of 2006, the prices of lead and zinc metal were at their highest levels in 20 years (see Exhibits 1 and 2 for historical lead and zinc prices). Approximately 55 per cent of domestic zinc was used in hot-dip galvanizing. Because additional galvanizing units were expected to be put into operation, the demand for zinc was expected to grow continuously. In 2006, domestic consumption and exports of lead-acid batteries, the main lead-consuming industry, had increased by 20 per cent and 35 per cent, respectively over 2005 levels. On the supply side, capacity growth was constrained by a lack of high-quality mines and limited smelter capacity.

SZLN forecasted that this growth trend in the demand for lead and zinc products would continue and, thus, increased its annual capacity to 180,000 tons of lead zinc ore and 400,000 tons of metal products. This expansion was financed by issuing 60 million new shares from which SZLN received proceeds of RMB700 million. Output of ore in 2007 was approximately 99,900 tons of zinc and 45,500 tons of lead. Metal output was 181,500 tons of zinc metal products and 92,200 tons of lead electrodes. Thus, the firm was required to purchase ore from both domestic and international companies to feed its manufacturing operations.

The prices of lead and zinc in 2007 fluctuated like a roller coaster. In a review of the competitive situation in 2008, SZLN made the following key observations:

- According to the data, the total capacity of the top 10 domestic lead zinc companies was less than 50 per cent of domestic total capacity, which indicated a fragmented industry.
- In 2007, upstream companies expanded downstream, and some downstream companies extended to upstream business, illustrating a trend to vertical integration.
- Industry competition intensified as a result of capital market developments. Because the stock market had performed abnormally well in 2007, many companies had taken the opportunity to issue additional shares to raise money for possible merger and acquisition opportunities. SZLN also raised money so it could expand, in hopes of surviving the imminent industry consolidation.
- Clearly, the government intended to consolidate the industry. As a result SZLN would likely either acquire other companies or would be acquired

SZLN's share of the segment's total gross profit reflected the company's changes in emphasis over time for various product lines (see Exhibit 3). The latest financial statements for SZLN are shown in Exhibits 4 and 5.

RECENT ACQUISITION ACTIVITIES

In June 2008, SZLN acquired a 55 per cent equity stake in Wuxuan Panlong Lead Zinc Co. Ltd. (Panlong Mine) at a price of RMB341 million. According to data provided by the Mineral Resources and Reserves Evaluation Center of China's Ministry of Natural Resources, Panlong Mine contained 19.7 million tons (Mt) of ore, 3.31 per cent grade of zinc and 1.05 per cent grade of lead. Given these estimates, the total of contained metals was 0.86 Mt.[2] As of September 30, 2007, the evaluated net assets of Panlong Mine were RMB620 million.[3]

Another takeover attempt in the overseas market had not been completed. In late December 2007, Indonesia Bumi had announced a hostile takeover offer for Australia Herald Resources Limited (Herald) at AU$2.25 cash per share. The main asset of Herald was an 80 per cent share of the Dairi project, which was located in Indonesia. As of June 30, 2007, the net assets of the project were estimated to have a value of AU$138 million. According to the announcement, the Dairi project contained 17.3 Mt of lead and zinc ore, with 13.1 per cent grade of zinc and 7.6 per cent grade of lead, ranking as the world's largest pre-production-stage lead zinc mine. In response, on January 30, 2008, SZLN and Indonesia PT Antam Tbk (Antam) set up a Special Purpose Vehicle (SPV) in Singapore — Tango Co. — which announced a tender for all outstanding shares of Herald (there were 202 million shares outstanding) at a price of AU$2.50 cash per share. The offer was conditional on Tango acquiring more than 50.1 per cent of the shares of Herald. Tango raised the tender offer price twice in June; however, on July 15, Herald announced it would accept Bumi's unconditional tender offer, of AU$2.85 per share, and SZLN gave up its takeover attempt.

In mid-November 2008, SZLN received information that PEM was seeking a strategic buyer, leading to a prompt response from Zhang and the management team. Due to the financial turmoil, lead and zinc prices had decreased dramatically, and PEM's stock price had crashed from AU$2.64 per share at the beginning of 2008 to AU$0.15 per share in mid-November. In addition, the Australian dollar had depreciated by one-third relative to the Chinese renminbi compared with six months earlier.

[2] The contained metals were computed as follows: contained metals = 19.7 Mt × 3.31% + 19.7 Mt × 1.05% = 0.86 Mt.
[3] The evaluated net assets method values the equity of a firm on the basis of the fair market value of its assets less its liabilities. This method is in contrast to the discounted cash flow method, which values the equity at the present value of future free cash flows to equity.