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Hildete de Moraes Vodopives

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THE GLOBALIZATION WAVE ROLLS TOWARDS CANADA, WITH VALE'S ACQUISITION OF INCO

Hildete de Moraes Vodopives
Université Paris Sorbonne

The internationalization of companies from developing countries is a novel feature of contemporary globalization. Inverting the trend of capital flows, they represent what the Boston Consulting Group calls the *Global Challengers*: "a group of emerging challengers that are becoming important players in both developing and developed countries around the globe.[1]" This article examines the case of one of these challengers: the Brazilian mining company Vale.

From the beginning of the 2000s, Vale was already a leader in the global production of iron ore, based on high quality and low cost reserves in Brazil. But its ability to face growing international competition came into question due to its under-diversification. After the acquisition of Canada's Inco in 2006, Vale jumped from the sixth to the second position among global mining producers.

Such a drastic move raises a number of questions. What reasons led this unknown emerging company to venture in an international merger? How does a developed society respond when a foreign company buys one of its traditional companies? And, finally: how successful was Vale in this endeavor?

1 – M. Aguiar, A. Bhattacharya, T. Bradtke, P. Cotte, S. Dertnig, M. Meyer, D. C. Michael, and H. L. Sirkin, "The New Global Challengers," *Boston Consulting Group*, Boston, 2006, p. 32.

In order to prepare to these questions, we are going to start with the analysis of the mining industry during the 1990s and 2000s. We want to understand what caused the industry's consolidation impulse and so many mergers over this period. Secondly, we will take a closer look into Vale's and Inco's backgrounds to examine the outcome of the operation.

The sources used in this research are threefold. As a public traded company, Vale and Inco are obligated to disclosure a significant part of their financial and operational data. These reports associated with those of the other competitors, provide a first layer of factual information on the subject. Investment bank analysts and industry consulting reports yield a more independent point of view while they test the management investment thesis and often optimist views. Finally, we performed a number of interviews with Vale's executives. When talking about 2006, they were able to express their personal views and evaluate what was the company's official strategy at the time in a critical perspective.

ABSTRACT

In the beginning of 2000s, mining company Vale was a leader in the global production of iron ore, whereas rich, high quality and low cost iron ore reserves in Brazil. But its scope was limited both geographically and in terms of diversity of products. After its privatization in 1997, the company establishes the priority of maximizing value for its shareholders. It became imperative to produce on a large scale and reduce costs. In this context, Vale sets goals to grow its presence internationally.

This article looks into what would become the capstone in the history of the internationalization of Vale: the acquisition of Inco in 2006. At the time, the Canadian company was the second largest producer of nickel in the world. After the transaction, Vale jumps from the sixth to the second position among global mining producers.

The move is ambitious and not everything goes as planned. Analysts perceive the deal as a risk and investors question the high debt structure. The post-acquisition adjustment is also difficult. The culture clash between Brazilians and Canadians results in loss of human capital and the expected benefits are delayed.

RÉSUMÉ

Au début des années 2000, la multinationale brésilienne Vale, leader en ce qui concerne la production mondiale de minerai de fer, occupait la 5e place dans le ranking du marché minier. Elle venait de subir une privatisation tout en étant en plein processus de restructuration. Dans les années qui ont suivi, l'entreprise mit en place un plan pour devenir une entreprise globale. Le plan fut audacieux. Motivée par la priorité de maximiser sa valeur au profit de ses actionnaires, l'entreprise chercha à produire à grande échelle et réduire ses coûts. Dans cette optique, Vale établit des objectifs pour diversifier des activités d'extraction minière parmi un programme d'acquisitions international.

Ce présent travail cherche à comprendre ce qui allait constituer le point d'orgue de l'histoire de l'internationalisation de Vale : l'acquisition d'Inco, en 2006. L'achat du deuxième plus grand producteur de nickel fut perçut comme un risque par les analystes. L'adaptation post acquisition fut difficile. La normalisation des structures, y compris des processus de gestion et des ressources humaines, ont été des challenges énormes.

L'internationalisation des entreprises venues des pays émergentes s'inscrit dans un sujet de mondialisation contemporaine. Dans le cas présent, nous poursuivons une recherche transdisciplinaire, impliquant l'histoire des entreprises, la géopolitique et l'économie. Les sources primaires incluent les rapports des conseils d'administration, des interviews, les analyses financiers internationaux et les documents publics au Canada et au Brésil.

JEL Classification : **G34, L12, L21, L22, L53, L72, N52.**

Key words : **globalization, internationalization, Canada, Valz, Inco, iron, nickel, Brazil, acquisition, national business culture, mining industry**

Mots clés : **mondialisation, internationalisation, Canada, Vale, Inco, fer, nickel, Brésil, acquisition, culture commerciale nationale, industrie minière.**

MINING INDUSTRY

The extraction of natural resources from the earth is the core definition of mining, an activity known to man since the beginning of time. Classifications may vary according to chemical properties, method of extraction or industrial use. For this study, we are interested in the economic relevance rather than technical aspects. Therefore, we will work with the classification of the United Nations statistical division[2] into six categories, as follows:

- Extraction of crude petroleum and natural gas (Fossil fuels)
- Mining of metal ores (gold, silver, copper, etc.)
- Mining and quarrying
- Mining of coal and lignite (Fossil fuels)
- Other mining and quarrying
- Mining support service activities

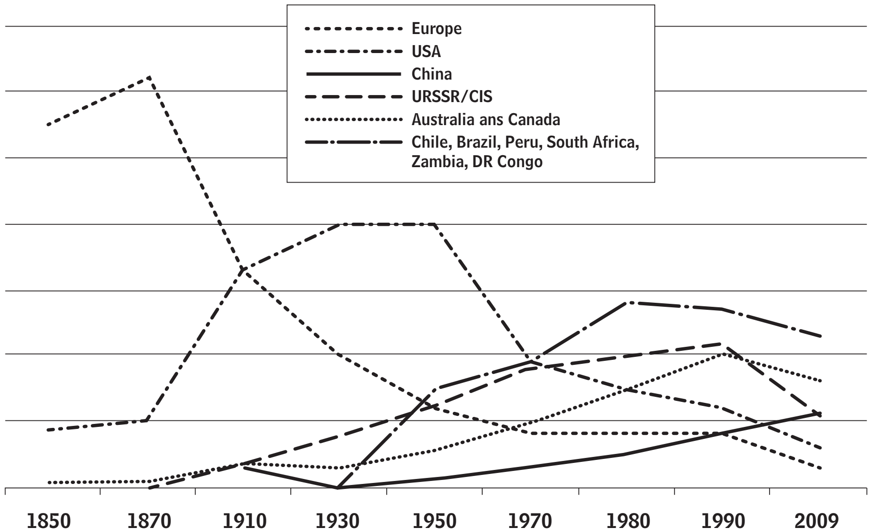
Of all non-fuel minerals, gold and iron ore were the most important in terms of total value of the production at the mine stage. But metal ores became particularly vital in modern societies, due to their intensive use in transportation, construction, manufacturing and communication. Appropriately, metal ore prices have been in close correlation with the global economic activity, following cycles of expansion and contraction. In the case of the iron ore industry, the commodity price was associated with the demand of the steel industry. During periods of declining economic growth, demand for steel products is bound to decrease.

Although mineral resources are present in different parts of the world, they are also limited and subject to depletion. From the managerial point of view, it is reasonable to explore the mines that are closer to the consumer markets and then move to more distant sites. That was what happened after the industrial revolution in the 1850s, when there was a drastic rise in the use of metals. The figure below shows the movements of the market share distribution. Exploration developed first closer to the industrial European countries and subsequently, in other parts of the world. According to a study[3] analyzing the geography of mining, in the 19th century, Europe accounted for more than 60% of the mining industry worldwide. This dominance was soon threatened by the rise of North America. In the 1930s, Europe's market share had fallen to under 30% while American's rose to around 40%. After the Second World War, American mining activity started to decline and developing countries became the next mining frontier. Brazil was thereupon identified as a region of abundant high quality iron ore.

2 – International Standard Industrial Classification of All Economic Activitie available at: http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=27

3 – Raw Materials Group, Stockholm, Sweden in Milton Hyland Ericsson, ICMM. *Trends in the Mining and Metals Industry's Contribution to Sustainable Development*, 2012.

FIGURE 1 **MARKET SHARE MINING EXPLORATION IN THE WORLD 1850-2009**



Source: Raw Materials Group, Stockholm, Sweden in Milton Hyland Ericsson, ICMM. By the beginning of the 21st-century, as the global economy accelerated, so did mining companies' appetite for expansion. The mining industry was dominated by a number of larger diversified companies and Vale was among large competitors BHP Billiton, Alcoa, Rio Tinto, Anglo American and Alcan.

THE BUYER: VALE

The Companhia Vale do Rio Doce was established by the nationalization and incorporation of two existing companies[4] in 1942. Vale's original mines were a minor industry of small furnaces using charcoal for fuel. The Second World War was in its third year and Western allies needed alternative suppliers of raw materials. Iron ore was on the top of the shopping list for the arms industries. For Brazil, this was an opportunity to step into prosperous developed markets. Still, when the war ended in 1945, both Great Britain and the United States relinquished their option to renew their contracts, leaving Vale without guaranteed markets. High maritime freight costs made it difficult for Vale to compete with companies that were closer to the consumer markets of Europe, United States and Asia.

In the 1960s, the problem was defined as "economic distance"; how to overcome the economic distance of a low cost commodity – iron ore – and deliver it to a distant market. Vale's CEO at the time, Elieser Batista, wanted to supply the Japanese steel industry, greatly damaged by World War II and in the process of reconstruction. Batista managed to reach scale economy by using large multipurpose ships that transported minerals to Asia and brought back oil

4 – The two companies incorporated were: Companhia Brasileira de Mineração e Siderurgia S. A., and Itabira de Mineração S. A.

from the Persian Gulf to Brazil. By doing so, Vale was able to compete with the miners from Australia, who were much closer to Japan. The search for productivity and scale would become part of Vale's business backbone.

In the next decade, the Brazilian upstart would emerge as the world's largest producer of iron ore. Searching to benefit from the world-class minerals assets in Brazil, Vale invested in a large-scale project pipeline. By the late 1980s, Vale consolidated the mining industry in Brazil and expanded its operations into two integrated systems,[5] each consisting of mines, railroads and port. Vale also operated pellet-producing facilities, six of which were joint ventures with international partners.

What was on the one hand its advantage was also a weakness. The iron ore supremacy made Vale heavily dependent on the iron ore economic cycle. In other words: when steel industry demand was weak, Vale would have cash flow problems.

After its privatization in 1997, a major transformation went underway. Although the Brazilian government kept a say in some strategic issues, it could no longer influence business strategies.

The new board of directors had one clear directive: to maximize the share value. As a result, in 2001 the company announced a multi-year strategic plan where the main goal was to transform Vale into a global player. The plan outlined clear principles:

– Maximize margins;
– Become a global multi-commodity mineral exploration program;
– Practice discipline of capital allocation;
– Evaluate relevant risks: market, regulatory, labor, tax, environmental, legal.

At that time, Vale was by far the mining leader in Brazil, but the potential of product diversification was limited. The company's international presence was remarkably modest which translated into virtually no market profile outside of Latin America. Vale had offices in Belgium, Japan, China and the United States, along with a participation in a steel company in California Steel.

It was under the leadership of Roger Agnelli, the newly appointed chief executive officer, that a more aggressive international acquisition plan took form. Vale started to restructure its business portfolio making opportunistic acquisitions - partially financed by divestitures in non-core business such as pulp and paper.

Vale diversified its portfolio investing in thermal and coking coal, copper, cobalt, platinum group metals, and fertilizer nutrients. Despite the company's efforts, iron ore remained its top revenue provider and Vale continued to be recognized internationally as a Brazilian iron ore company. Gradually, the idea of buying a major North American mining company was taking shape.

5 – The Southern System, based in the states of Minas Gerais and Espírito Santo, contains aggregate estimated proven and probable iron ore reserves of approximately 2.3 billion tons. The Northern System, based in the states of Pará and Maranhão, contains aggregate estimated proven and probable iron ore reserves of approximately 1.2 billion tons.

Canada was a traditional mining country, with high quality assets and a qualified workforce. The ideal candidate could be one of the large Canadian companies, such as Alcan, Falcondrige, Noranda and Inco.

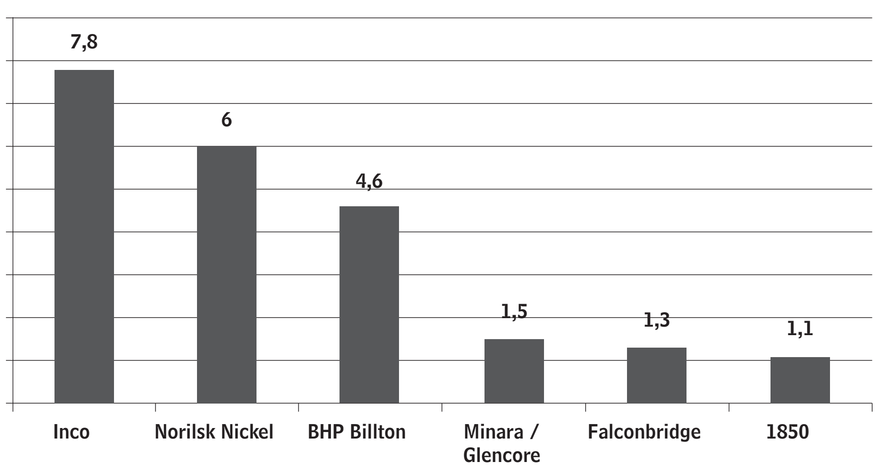
THE TARGET : INCO

The International Nickel Company of Canada Ltd – Inco - was established in 1916 as the Canadian subsidiary of an American company based in New Jersey. Twelve years later, the Canadian branch became the parent company through an exchange of shares and the headquarters moved to Toronto. It was the first step of a history of growth, which transformed Inco in one of Canada's elite multinationals, producing ; nickel, cobalt, copper and precious metals.

Inco had impressive attributes. The company had a growth pipeline of projects including the world's largest mining camp, the nickel-rich Sudbury basin in Ontario. Internationally, it operated mines in the United Kingdom, Indonesia and New Caledonia together with interests in refineries in Japan, South Korea and Taiwan. Overall Inco came to be the largest nickel producer, owing the world's largest nickel reserve base and accounting for about 25% of the global production.

Besides, Inco was reputed for its technical advancements. Having been awarded numerous prizes for its productivity and technology breakthrough in the industry, the company was in the lowest quartile of costs in the industry. Due to these factors and to its superior quality reserves, Inco built a premium portfolio that was commercialized through a marketing network in over 40 countries.

TABLE 1 **COMPARISON OF NICKEL RESERVES**



Source : Presentation Vale, "A new step towards value creation," Vale, 2006. (Millions of tons of nickel)

In light of optimistic demand forecasts, Inco and Falconbridge bid for the control of one of the most significant discoveries of nickel in the world: the Voisey Bay project. Located north of the province of Labrador, Voisey Bay comprised nickel-copper-cobalt mines and a port in the Bay of Anaktalakun. Inco was the winner paying the remarkable price of 4.5 billion US dollars.

It didn't take long for Inco to realize that it was an expensive price tag. The project valuation considered a price of nickel that had reached a new maximum that year, therefore inflating projections and multiples. Voisey Bay's rate of return assumptions proved unrealistic. As a consequence, Inco was forced to conduct an impairment of a third of the project value; an irreparable reverse to Inco's expectations. When demand bounced, Inco was not prepared accordingly. The board was reluctant to embrace new investments after the trauma of Voisey Bay, putting the company in a weaker position. Miners around the world were competing to dominate the market. The leaders had their own integrated facilities, including exploration, processing, refining and marketing of nickel. In 2003, Inco lost world leadership in the supply of nickel to the Norilsk Nickel Group.

TABLE 2 **MAJOR NICKEL MINING COMPANIES IN 2005**

Company	Mine production, (tonnes)
Norilsk	243 000
Inco	223 811
BHP Billiton	174 900
PT Antam	80 000
Cubaniquel	75 000
Jinchuan	71 000
Falconbridge (Xstrata)	64 002
Eramet	59 576
Anglo American plc	47 400
Votorantim Metals Ltda	22 000

Source: BHP Minerals Companion

Scott Hand, Inco's CEO, was convinced Inco could regain its prominent place in the industry by merging with Toronto-based Falconbridge[6], a strategic player with huge minerals operation in Sudbury. But as the Canadian newspaper *Globe & Mail* described; there would be no happy ending for Inco. In a scathing piece, the *Globe* summarized Inco's situation:

> "[A] … debilitating mix of corporate caution, personality clashes, political naiveté and shareholder revolts would weaken Canada's mining contenders

6 – Governance note: Brascan's holdings had a 41% stake in Noranda, a company that collected a 60% stake in Falconbridge.

> at the very moment they needed to be strong. In the first decade of the 21st century, Canadian greats - from the Hamilton steel maker Dofasco Ltd. to the Vancouver resort operator Intrawest Corp. - were being gobbled up by foreigners. And mining, so quintessentially Canadian, was to be no exception. A business fantasy, of creating a Canadian global giant, was about to disintegrate into a Canadian tragedy."[7]

On the edge of an unprecedented commodities boom, Swiss mining company Xstrata and Vale were ruthlessly fighting for a place in Canadian corporate history. Vale was unsuccessful in its various attempts, including the traumatic move to buy Alcan. Xstrata won the bidding war for Falconbridge.

THE DEAL

Inco turned to be the North American bedrock that would finally grant Vale the breakthrough of its internationalization. The proposed transaction was an all-cash offer to acquire 100% of outstanding common shares of Inco Limited. The price of 86 Canadian dollars per share was based on a valuation methodology quantifying the recognition of Inco's value and the synergies for the combination of the two companies. Four banks were used in the transaction: ABN Ambro, Credit Suisse, UBS, and Santander.

By Latin American standards, the 18.68 billion US dollars was a scary price tag. Investors and analysts questioned the high debt ratio that the company would be exposed to. The company was confident that Vale's stable cash flow would provide the financial flexibility to cope with the transactions' obligation even in a stress scenario. Vale argued that by the end of that year it would have the same ratio total-debt-to-EBITDA; around the same numbers the company had in 2002: slightly below 2.

Another concern on the mind of Vale's directors was to keep Vale's investment grade position. The rating agencies could take a negative outlook on the increase of leverage. The company's chief financial officer Fabio Barbosa and Agnelli went to New York to present the rationale of the transaction to the four rating agencies, Standard & Poor's, Moody's, DBRS and Fitch. In a conference call with analysts, Agnelli stressed his they could work with that level of leverage for a short period of time.[8]

Most of all, the expectation was that the combination of Vale's and Inco's leaderships with Vale's strong iron ore cash generation, would place the company in an advantageous position in the market. Inco could speed up Vale's insertion in the non-ferrous segment. With one stroke, the company would come to be second in the nickel production with a clear path to becoming the number

7 – Jacquie McNish, "The great Canadian mining disaster," *The Globe and Mail*, [s.l.], 2006, p. 1-27.
8 – Vale, Transcript CVRD offers for Inco conference call, August 11, 2006.

one. It also would turn second in the manganese and ferroalloys ranking. Furthermore, considering its organic pipeline, the company could soon occupy the #2 position in bauxite and #3 in alumina.

PROBLEMS FACED BY VALE IN CANADA

The conclusion of the deal was a celebrated event and the feeling of empowerment took over Vale. Agnelli estimated that the good relationship established with Inco's counterparts in their conjoint Brazilian projects (Vermelho and Onça Puma) would set a friendly collaboration.

But, the post-acquisition adjustment proved to be difficult first Brazilian executives who arrived in Toronto to take ownership of Inco found an unwelcoming atmosphere. Ahead of the Brazilian team was Murilo Ferreira, who had been one of the top negotiators on Vale's side. "The first conversation between the two teams of Vale and Inco was kind of awkward," said the Canadian Scott McDonald, vice-president of human resources at Inco in an interview to Brazilian magazine Exame[9]. Canadians were under shock. Inco was one more of a series of companies that had been bought by foreigners. study[10] among Canadians executives reveals that four out of five Canadian CEOs thought that the government should impose restrictions on acquisitions by outsiders.

Ferreira and other Brazilian executives[11] admit today that Vale's attitude was know-it-all and left no space for negotiation with Inco's established corporate traditions. Accustomed with Vale's overpowering in its local market where the company was by far the major player in the mining industry, Brazilians took Inco's employees for granted. Trying to impose their way of doing things, they were perceived as arrogant. As a result, an impressive number of qualified employees left the company following the takeover, including senior managers, key engineers and operating staff.

Public opinion in Canada resented the acquisition of one of its iconic companies to a third world unknown outsider. As a local newspaper The Star pointed up:

> "My story would be about the culture of a company town from the perspective of generations of men who went down the mines, or worked in the smelter or refinery, at what used to be Inco. That seemed the best place to start, given that Inco's owner since 2006 – Companhia Vale do Rio Doce – insists the working culture of its new operations must change. By

9 – C. Mano, "A saga da Vale fora do Brasil," *Revista Exame*, São Paulo, 2007, p. 1-5.
10 – *Ibid*.
11 – Ferreira, interview, *op. cit*.

that, the Brazilian behemoth that bought Inco for $19.4 billion, creating Vale Inco (now simply Vale), means lower costs and higher production."[12]

Conflict reached climax in 2009. First, Ferreira decided to leave the company after disagreeing with Agnelli's strong personality.[13] Secondly, over 3,000 Sudbury workers went on a one year-long violent strike, to protest against changes in the pension plan benefits.

CONCLUSION

The acquisition of Inco is recognized as the key strategy of Vale's internationalization. As a former state-owned firm from an emerging economy, Vale recognizes its deficiencies facing a growing competitive global market. By drafting a strategy focused on market expansion and efficiency seeking, management complies with the insignia of the value oriented publicly traded company.

The experience of stepping in a completely different country – Canada – proved to be a challenging experience. Brazilians underestimated how much Canadian pride had been hurt in the process. The culture clash between Brazilians and Canadians resulted in loss of human capital and compromised expected synergies.

All in all, Vale put in place a global multi-commodity mineral exploration program aiming diversification of portfolio, markets and geographic asset base. Simultaneously, Vale seized a better business and financial risk perception, which subscribed a lower cost of capital. In that, there is no question that the company succeeded. Vale took a place among the three largest diversified mining companies in the world, along with BHP Billiton and Rio Tinto.

Throughout this study, some new questions have arisen. In the course of the early years of the 2000s, the financial world – investors and hedge funds – become a significant stakeholder in the mining industry. Some cases indicate that companies that failed to adapt strategies accordingly seem to have lost market share. Meanwhile, more sophisticated standards of corporate governance include the agenda of intangible assets as brand and environmental impact.

Another line of investigation has to do with conflicts between the mining companies with indigenous communities from different countries. Vale had to deal with difficult situations in Brazil, Canada and New Caledonia. Where the problems have similarities and if there was a transfer of know-how allowing the elaboration of a corporate indigenous program are questions that interest both the anthropological and the managerial scholars.

12 – Linda Diebel, "Inside Sudbury's Bitter Vale Strike," *The Star*, June 6, 2010.
13 – Murilo Ferreira, interview with the author, Rio de Janeiro, 2014

Finally, in light of the events that followed the acquisition of Inco, it is entangled to establish if Vale is a proved global player or if it would be better defined as an international Brazilian company. The case of Vale's acquisition of Inco was the first concrete case of a Latin American company venturing outside the region. It would for a long time be the largest foreign acquisition in that part of the world. But despite this remarkable accomplishment in less than a decade, the company remains managed almost exclusively by Brazilians, with a clear predominance of the local business culture. Establishing a longer period of analysis would give a better perspective on the challenges that a culture such as Brazil's – isolated for so many years and with such specific international experience – presents to forge genuine global players.