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A Hot Commodities Market Spurs Buying Spree by Manufacturers

By TIMOTHY AEPPEL

Shortages and high prices for raw materials are fueling a new and unusual wave of acquisitions and deals. Steelmakers are buying iron-ore mines, airplane manufacturers are striking long-term deals for titanium, and the world's second-largest tire maker is cultivating rubber trees.

This return to a type of vertical integration that has been out of favor for decades signals a new phase of industry consolidation. Having bulked up by acquiring rivals, manufacturers are turning their deal-making prowess to raw materials providers in hopes of ensuring adequate supplies and controlling costs.

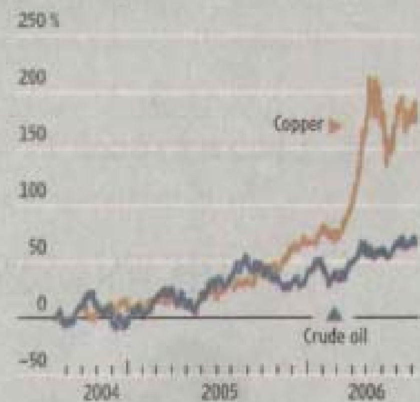
The trend reaches beyond raw materials to crucial parts. Armor Holdings Inc., a maker of armored cars and bullet-proof vests, last month bought Integrated Textile Systems Inc., a Monroe, N.C., supplier of super-strong fibers. The fiber producer had come up with a low-cost and environmentally friendly way to make fibers for reinforcing armored cars.

Auto makers and steel companies historically sought to own everything from raw-materials stocks, manufacturing plants and sales outlets. But vertical integration lost favor in the past century because of inefficiencies.

Now, the pendulum is swinging back as some manufacturers aim to smooth volatile prices and better plan for the ebb and flow of material scarcity. But rather than own everything, they hope to control only those components or materials that are most scarce or most difficult to produce.

On the Run

Change in futures prices over the past two years



Source: Thomson Datastream

The trend is part of the larger merger wave reshaping many industries. So far this year, data provider Dealogic has counted 475 deals worldwide in metals and steel, valued at $71.7 billion, up sharply from 398 deals valued at $24.3 billion during the same period last year. In machinery, there have been 499 deals, valued at $24.8 billion, up from 346 deals valued at $14.2 billion a year ago.

It is unclear how many of these are aimed at locking up providers of expen-

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sive or scarce materials. The vast majority, of course, are among companies that want to get bigger, using economies of scale to wring price concessions from suppliers.

But unlike earlier consolidation waves, this one is occurring deep in the manufacturing food-chain, and being driven by surging commodity prices. Copper is up a stunning 192% over the past two years, nickel 103%, natural rubber 72%, and oil 67%. Another cause: severe price fluctuations that have roiled production, causing costly shutdowns and missed deliveries. The price of cold-rolled steel in the U.S., for instance, has been on a roller coaster, surging to $700 a net ton in June, up from $590 a ton a year earlier, but about on par with prices in June 2004.

"When inventories of so many key materials are this tight, there's an extreme incentive for companies to seek greater control over supplies," says Jason Schenker, an economist at Wachovia Corp.

Steelmakers are among the most aggressive. Just four years ago, Pittsburgh-based U.S. Steel announced it was spinning off its Minnesota iron-ore operations to focus on steelmaking. The company's union balked and blocked the move, which proved a blessing. As prices of raw materials have soared, the lack of vertical integration came to be considered a major weakness in that industry, and many steel producers are rushing to assert even more control over raw materials.

The world's biggest steelmaker, Mittal Steel Co. N.V., based in Rotterdam, the Netherlands, has stated that it will be 82% self-sufficient in iron ore by 2010, while Novolipetsk Steel, Russia's fourth-largest steelmaker, earlier this year spent $750 million for stakes in two coking-coal producers. Novolipetsk's stated goal is to become self-sufficient in raw materials.

Other manufacturers are testing long-term deals or using their industry contacts to guarantee adequate supplies for themselves and their suppliers. Airbus,

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the European airplane consortium, in May announced it had signed contracts with titanium suppliers worth $1.4 billion to secure the scarce metal through 2015—an unusually long time horizon for any industry.

Boeing Co. tried another tack to lock up titanium supplies, announcing a joint venture with Russia's OAO VSMPO-Avisma, the world's largest titanium producer, to supply components for its new Dreamliner jets. The 50-50 joint venture requires an initial investment of $30 million each. Boeing, based in Chicago, said the deal will cut the cost of titanium parts.

Open Energy Corp., a Solana Beach, Calif., maker of solar equipment, uses its contacts to buy hard-to-get silicon ingots for suppliers. "In a normal supply-chain environment this wouldn't be happening and the fact we have to do it is not ideal, because it ties up capital," says David Saltman, the company's president. But the alternative is costly shutdowns because of shortages. Harris Corp., a Melbourne, Fla.-based electronics company, helped its metal-parts suppliers line up new electroplating companies that they could use to meet Harris's anticipated demand for parts.

We are seeing companies "reintegrating on a virtual basis," says John Baron, vice president of business development for Newview Technologies Inc., a software and services company that helps Ford Motor Co. and Britain's Rolls-Royce Group PLC manage raw materials. It can mean buying materials on behalf of a group of parts suppliers or helping suppliers better forecast their own needs.

In the tire industry, Japan's Bridgestone Corp. last year bought an Indonesian rubber plantation and is helping farmers in other parts of the world plant more rubber trees. The company, the second-largest tire maker in the world based on sales after France's Michelin SA, is also pouring money into plants to make other crucial raw materials such as carbon black.

Mark A. Emkes, chief executive of Bridgestone Firestone North American Tire LLC and a member of the board of Bridgestone in Japan, says his "company has determined that in the long term, the global appetite for these strategic raw materials will make it more and more difficult to obtain the quality and quantity of materials necessary for the efficient and profitable operation of the business."

Some companies pursue the strategy in order to boost output of new materials or block competitors from gaining control of them. Japan's Toyota Motor Corp. last year took control of its key supplier of batteries for gasoline-electric hybrid cars, which use large amounts of nickel. Rapid growth of hybrids has strained the ability of battery makers to meet demand. Crocs Inc., based in Niwot, Colo., bought the technology to make the resin it uses in its distinctive clog-like shoes.

Integrated Textile's clean processes are one reason its bullet-proof fibers can be produced less expensively than rivals, says Robert R. Schiller, president of Jacksonville, Fla.-based acquirer Armor Holdings. Armor Holdings' purchase of the fiber company will expand output of the new fiber. That would have been harder for the supplier to do on its own, he says, while "providing us control over a core ballistic technology with unique properties."

Hyundai Motor Co.

Hyundai Motor Co. said it plans to launch a new premium sport-utility vehicle in South Korea in October, hoping to lift sluggish domestic demand. The SUV, to be named the Veracruz, will be equipped with a 3.8-liter, V6 engine and six speed automatic transmission, Korea's largest auto maker said. The Ver-