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Rio Tinto redux

comments

Thursday, 26 November 2009 | Damon Frith

Few chief executives have gone through as much in the past 24 months as Rio Tinto boss Tom Albanese, and even fewer have survived such an ordeal.

Tens of billions in debt, besieged by shareholders for spurning a huge offer from BHP Billiton, resented by Chinese would-be rescuers for spurning them in turn, and thrust to the centre of a diplomatic spat between Australia and China, the phlegmatic and softly spoken Albanese suggests that the old-fashioned leadership virtues still help the most.

"It's important for a chief executive to have strength of character and a bit of a thick skin," he says. "It's come in handy over the past year.

"It was very important to make necessary, difficult decisions and in my view always do so with a smile. People are always watching to see if you have a smile on."

In a week or so, Albanese may have something else to smile about. His iron ore chief, Sam Walsh, is expected by December 5 to deliver a binding agreement with former nemesis BHP Billiton to combine their iron ore efforts in Western Australia's Pilbara region - although there are still reports of obstacles to a deal.

The joint venture is the cornerstone of the new and reinvigorated Rio that is now emerging. Should it falter, however, Rio will be back in BHP's sights.

Once the as-yet-unnamed joint venture gets going in mid-2010 with Walsh as its first chairman, the two miners expect to squeeze at least $US10 billion ($10.8 billion) in operating savings from combining neighbouring mines into single operations, optimising product offerings through ore blending, merging management, procurement and general overheads under a single organisation, and improving production planning and port and rail use. BHP will pay Rio $US5.8 billion to lift its equity stake in the joint venture from 45 per cent to 50 per cent, giving the new entity a valuation of $US116 billion.

This may be just the start, Albanese says. Once managers have worked through the initial integration, more gains will follow. "Our history with North [Rio bought diversified miner North for $3.5 billion in 2000] and more recently Alcan shows the next-generation mangers will come up with ideas and benefits that have not yet been anticipated," he says.

Iron ore is central to both Rio and BHP, but it has been the abrupt and unexpected emergence of China earlier this decade and its desperate need for nation-building materials as it industrialises that has driven home to both companies the need to join forces to create a supplier capable of holding its own against the growing might of the Chinese buyer.

For Rio, the venture is the best option for substantially upgrading its Pilbara operations. It has spent $US8 billion since 2003 boosting its production to 220 million tonnes of iron ore a year and it has plans to spend a further $US4.5 billion by 2012 to lift output to 330 million tonnes.

BHP is also in an expansion phase to increase its production by 50 million tonnes a year to 205 million tonnes by 2011. Merging the Pilbara operations is BHP's second-best option - its first being a full takeover of Rio.

This is at least a technical possibility again. The United Kingdom takeover rule that prevented BHP from re-bidding for 12 months has just lapsed. The head of equities at fund manager Perpetual, John Sevior, says the reasons for BHP to make a bid for Rio are still relevant and compelling, and that if the joint venture falls apart BHP may return with a bid.

For Rio, however, the venture is the best chance of removing itself from BHP's ambitions for good. Albanese is hesitant when asked if he received a specific guarantee that BHP would not bid for Rio as long as the joint venture goes ahead. Finally, he says, "I can't anticipate what others will do - all I can do is say from a shareholder prospective it makes a lot of sense", suggesting a final halt in BHP's designs on Rio may have been part of the discussion.

Rio's wild ride began in July 2007 when it paid a top-dollar $US38.1 billion for Canadian aluminium group Alcan. Shortly after the deal's completion, the credit crisis began in earnest, cruelling the prospects for companies that had borrowed heavily to fund acquisitions. In November that year, BHP emerged with its proposed scrip offer for Rio as Rio's share price broke through $100. Six months later, it had hit a high of $123.12. Seven months after that the shares were at a low of $25.63, by which time BHP had walked away, citing Rio's unmanageable debt. The shares have since risen steadily back up to about $70 each.

London-based BlackRock Investment portfolio manager Evy Hambro sees the BHP offer as a defining moment for Rio. "It prevented management from getting on with planned asset sales that would have made the Alcan acquisition manageable," he says. "Suddenly, they had to pull back and focus on BHP."

Rio's aluminium operations are still a thorn in its side: there is so much idled production globally that can easily be brought onstream that there are fears the industry's long-term structural issues will take a long time to unwind.

Hambro says one thing that may help Rio is a global agreement on carbon tax. Such a tax will hit the aluminium industry hard but Rio will be largely protected as its main plants run on hydro-electricity, dramatically cutting their greenhouse gas emissions footprint.

Albanese does not dwell on the BHP offer, but notes the pressures on the company in the latter part of last year as mineral demand and prices collapsed. "We very quickly had to move the organisation and respond extremely aggressively and decisively in the fourth quarter of last year from what was a growth environment to one which was absolute cost, capital and people compression. The shift from full order books and shipping schedules to basically empty docks was very rapid."

In desperation, Rio turned to the Chinese government enterprise Chinalco as its saviour, announcing a $US19.5 billion alliance that would have given Chinalco substantial stakes in key Rio assets, particularly in Australia. Rio scrapped the deal on June 6 as equity markets recovered more rapidly than expected.

A capital raising rather than a sale was not only possible - it was being demanded by Rio institutional shareholders, particularly in the United Kingdom. The same month, Rio raised $US15.2 billion from UK and Australian shareholders and its asset sales in recent months have topped $US9 billion. As a result, Rio's debt dropped from an uncomfortable $US38 billion at the start of 2009 to a workable $US22.3 billion at the end of September.

Rio is far from digging itself out of trouble, but the global investor briefing at the end of October was a small milestone. When the floor was opened for questions, there was no rebuke for Albanese on Rio's string of misadventures. He says he was not surprised. "We have had a lot of engagement with our shareholders about the events of the past two years. They say to us: 'We understand the past, you've told us about the past and now we want you to tell us about the future - what are your plans?' "

In this respect, Rio announced that capital expenditure plans for next year had doubled from $US2.5 billion to $US5 billion with the possibility of lifting to $US6 billion with bolt-on acquisitions. For the first time in almost two years, the word acquisition was not referring to a disaster.

The change had been coming for pretty much all of this year, both in production figures and in the successful pursuit of asset sales and getting back on track with new project developments. There is also a rumour that Rio's aluminium division is going to be a surprise profit earner in the second half as the company has managed to make huge cuts to production costs.

The improved performance across the operations has come as no surprise to Sevior: "Rio has one of the best collections of resource assets in the world, and if you strip out the corporate shenanigans, where they have conducted themselves poorly, the operational management is pretty good."

Nor did Rio suffer the mass exodus of staff and management seen frequently at troubled companies. Albanese gets serious when he talks about his people: "Through a period of corporate activity and uncertainty, more than most companies ever see, we had a low level of turnover in people. People recognised this is a company they wanted to see succeed and worked to support me and the organisation and board to make it succeed. I'm very proud of that.

"We have delivered in the first half of the year better than expected production and cost reductions. Third-quarter production was very strong and better than expected and we delivered significant improvements in safety. For me, it means line management is on the ball and people aren't distracted."

Albanese has not resumed evangelising on the Chinese growth story and the 20-year super cycle that both he and his BHP counterpart Marius Kloppers preached in mid-2007 - but he is seeing some light. "Two years ago, people talked about decoupling, with China and India moving at a different pace [from the west]. Decoupling became very unpopular as a concept in the second half of last year as China slowed down so rapidly. As we have seen government stimulus kick in during the year, economic recovery in China has been quite strong. We might see the term decoupling re-emerging."

For Albanese, decoupling has a simple meaning: China will boom while the Organisation for Economic Co-operation and Development drags itself only slowly out of recession. When normal growth does return in the OECD, it is going to create supply-side problems for key commodities.

Both Albanese and Kloppers have argued for several years that too much attention is given to the demand side of the equation, and that observers fail to realise there are insufficient new developments and clearing of infrastructure bottlenecks taking place globally to meet demand from existing and planned consumption.

Hambros agrees but expects the Chinese capital available for resource projects globally will prevent a supply-shortage crisis, and in the long term will generate a supply surplus for the main commodities.

Analysing Rio Tinto

Strengths
The group has one of the world's best suites of mining assets and after recapitalising its balance sheet and conducting an asset-sale program over the past 12 months it again has the financial muscle to progress new projects. Also, the new chairman, Jan du Plessis, is doing well in restoring confidence in the board of Rio Tinto following what can only be described as the disastrous final two years for former chairman Paul Skinner.

Weaknesses
High exposure to aluminium is a threat to growth as the metal is facing large structural issues globally that could make it a second-class commodity for years to come. Any further hiccups in strategy or disappointment in management decisions could quickly translate into share price weakness.

Opportunities
Rapidly getting the profile of the aluminium operations down the cost curve would greatly improve overall profit outlook. Progress on the next generation of first-tier assets such as the Oyu Tolgoi copper-gold project in Mongolia will maintain Rio's long-term growth outlook, and finalising the Rio-BHP joint venture will bring great benefits to both companies.

Threats
Any further deterioration of Rio's relationship with China. The company also remains a takeover opportunity for BHP, although this has good connotations for the share price. The iron ore joint venture has not yet been consummated.

To China, with love

For Rio Tinto to continue to deliver, its relationship with China must improve.

Chinese officials are still fuming over being sidelined by the Rio-BHP Billiton iron ore tie-up, which was exacerbated by the arrests in China on July 5 of four Rio employees on charges of bribery and industrial espionage. The case has yet to go to trial and the arrested employees remain in detention.

However, Chinaclo is still Rio's largest shareholder with 9 per cent. It took up its full entitlement in the rights issue and is mentioned repeatedly by Albanese as an important partner.

"I would like to see opportunities to work together with Chinalco on new projects the world over," he says. "It could be development projects, existing businesses, or we could create opportunities for mutual engagement on projects. I've just been to China recently and I think we are seeing an improvement in the relationship. It's been a difficult six months with a whole range of issues, Chinalco was one, and the arrest of four of our employees is certainly an important issue for me and the organisation - but also the lack of a settlement in iron ore pricing with China this year brought a lot of tension.

"That all said, I think there is a greater recognition now from our perspective that we want to work with China and think China recognises they need mining companies like Rio Tinto working with them to ensure they have the supply of materials they need for ongoing growth."

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