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ValueLine: Rio Tinto

By Roger Montgomery

PORTFOLIO POINT: Rio Tinto's fortunes are so closely tied to China that any 'speed bumps' in Chinese demand would hit the company hard.

Glancing over yet another set of numbers as reporting season draws to a close, my mind started to wander as I waded through forecasts for one, two and three years hence. I began to consider what might happen that could take the shine off these elaborate constructions and which companies are in the firing line.

Consider Rio Tinto, which, in an effort to make itself "takeover proof" back in 2007, loaded its debt up to $43 billion to acquire the Canadian aluminium company Alcan. It paid top-of-the-market multiples just 12 months before the biggest credit crunch in living memory forced it to sell assets, raise capital and destroy huge amounts of shareholder value.

Do you think Rio's managers saw that coming when they were compiling their one, two and three-year forecasts?

Before I elaborate on events that could unfold, allow me to indulge in a bit of history and take you back to the mid-1990s when I was in Malaysia and the Kuala Lumpur skyline was filled with cranes because of a credit-fuelled speculative boom. It was the same throughout the region.

A year or so after my visit, the Asian tiger economies were in trouble and the Asian currency crisis was in full flight. These are the returns that are produced by unjustified, credit-fuelled "investing" unsupported by demand fundamentals.

In December 2007, as I travelled to Miami, I experienced a distinct feeling of déjà vu as I once again witnessed residential and commercial property construction fuelled by low interest rates and easy credit and unsupported by demand.

These are not isolated incidences. Japan, Dubai, Malaysia, the US. Credit fuelled speculative property booms always end badly.

So what does this have to do with your Australian share portfolio? Australia's economic good fortune lies in its proximity – and exports of coal and iron ore – to China. Much of those commodities go into the production of steel, one of the major inputs in the building industry.

In China today there is, presently under construction and in addition to the buildings that already exist, 30 billion square feet of residential and commercial space. That is the equivalent of 23 square feet for every single man, woman and child in China. This construction activity has been a key driver of Chinese capital spending and resource consumption.

About two years ago if you looked at all the buildings, the roads the office towers and apartments under construction the only thought to pop into your head would be to consider how much energy would be required to light and heat all those spaces.

But that won't be necessary if they all remain empty. In the commercial

The ValueLine portfolio, as at March 2, 2010

Company	Buy price	Price today	Est value**	Margin of safety	Shares bought	Invested	Capital value	Divs rec	Total return	Total return
JB Hi Fi	14.8	19.92	19.65	-1.4%	845	$12,500	$16,824	0.62	$4,848	38.78%
Cochlear	56.36	65.08	56.3	-15.6%	102	$5,744	$6,633	1.97	$1,089	18.97%
CSL	31.81	34.77	32.87	-5.8%	163	$5,197	$5,681	0.4	$549	10.56%
Woolworths	26.16	27.66	26.85	-3.0%	206	$5,377	$5,686	0.56	$423	7.87%
Reece	17.8	25	17.78	-40.6%	236	$4,209	$5,912	0.33	$1,781	42.30%
Platinum Asset Mgt	4.06	5.66	4.45	-27.2%	854	$3,467	$4,833	0.12	$1,469	42.36%
CommBank	46.51	55.15	47.37	-16.4%	215	$10,000	$11,857	1.2	$2,116	21.16%

Since July 1, 2009

Security Value	$57,426
Cash Value	$57,268
Total Value	$114,694
Total Return ($)	$14,694.03
Return Invested (%)	30.46%
Total Return (%)	14.69%
All Ordinaries change	20.30%

***Last Intrinsic Value update 3/3/2010*

Negative Watch

Company	July 1 price	Price today	Est value	Margin of safety*	Divs rec	Total return
ISOFT	0.635	0.535	0.19	-181.6%		15.75%
Amcor	4.79	5.8	3.63	-59.8%		-21.09%

* Outperformance (I): Outperformance of Invested Portion	10.16%
* Outperformance (T): Outperformance of total portfolio	-5.61%

How Rio Tinto's share price has moved

sector, the vacancy rate stands at 20% and construction continues to build a bank of space that is more than required for a very, very long time.

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Because of this I am more than a little concerned about any Australian company that sells the bulk of its output to the Chinese, to be used in construction. That means steel and iron ore, aluminium, glass, bricks, fibre cement … you name it.

Last year China imported 42% more iron ore than the year before, while the rest of the world fell in a heap. It consumes 40% of the world's coal and the growth has increased Australia's reliance on China; China buys almost three-quarters of Australia's coal exports – 280 million of their 630 million tonne demand.

The key concern for investors is to examine the valuations of companies that sell the bulk of their output to China. Any company that is trading at a substantial premium to its valuation on the hope that it will be sustained by Chinese demand, without a speed hump, may be more risk than you care for your portfolio to endure.

The biggest risks are any companies that are selling more than 70% of their output to China but anything over 20% on the revenue line could have major consequences.

BHP generates about 20%, or $11 billion, of its $56 billion revenue from China; and Rio 24%, or $11 billion, from its $46 billion revenue. BHP's adjusted net profit before tax was $19.8 billion last year and Rio's was $8.7 billion.

While BHP's profitibility would be substantially impacted by any speed bumps that emerge from China, the effect on Rio Tinto would be far worse.

According to my method, Rio Tinto is worth no more than its current share price and while the debt associated with the $43 billion purchase of Alcan is declining, the dilutive capital raisings (so far avoided by BHP) have been disastrous for shareholders.

As a result, return on equity is expected to fall from 45% to 16% for the next three years. Most importantly the massive growth in earnings for the next three years is driven by the ever-optimistic analysts who are relying on China's growth extending in a smooth upward trajectory.

Go through your portfolio: do you own any companies that supply directly or indirectly, the Chinese building industry, have more than 70% of their revenues or profits reliant on China and are trading at steep premiums to intrinsic value?

Make no mistake: Australia's future is written inside a fortune cookie – some companies' more than others. ◆

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