EUREKA *report*

Time to break up BHP?

By Tim Treadgold
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PORTFOLIO POINT: BHP could be worth a lot more broken into its component parts than the conglomerate it has become.

Is BHP too big? Too big to do a takeover, too big to make the sort of money its shareholders know is contained in its magnificent suite of mining assets? Suddenly the question is being asked among investors and brokers alike because the "big Australian" is paying a high price for its giant scale.

Three successive takeover attempts have now been thwarted: A bid for Rio, a bid to merge Pilbara assets with Rio and now a deal to buy Canada's PotashCorp. It seems governments at state and federal levels simply don't trust a company so big.

What's more, money is pouring out the back door as BHP fails to grab a new growth option. BHP chairman Jac Nasser conceded this week the company has spent a staggering $850 million on the three failed takeover deals … maybe there is a better way.

A simple examination of the iron ore division alone produces a theoretical value that matches the current market capitalisation of the entire company.

Big brokers, such as UBS and Goldman Sachs, are predicting iron ore earnings, before interest and tax (EBIT), in the current financial year of more than $US12 billion. UBS said $US12.8 billion in a report circulated on Monday. Goldman said $US12.4 billion on the same day.

If a notional price/earnings multiple of 12 is applied to those EBIT numbers – and this is a classic best-guess "back of the envelope exercise" – an independent iron ore business valued at $US144 billion on the stockmarket emerges, roughly the same as today's valuation of the wider parent company ($A146 billion).

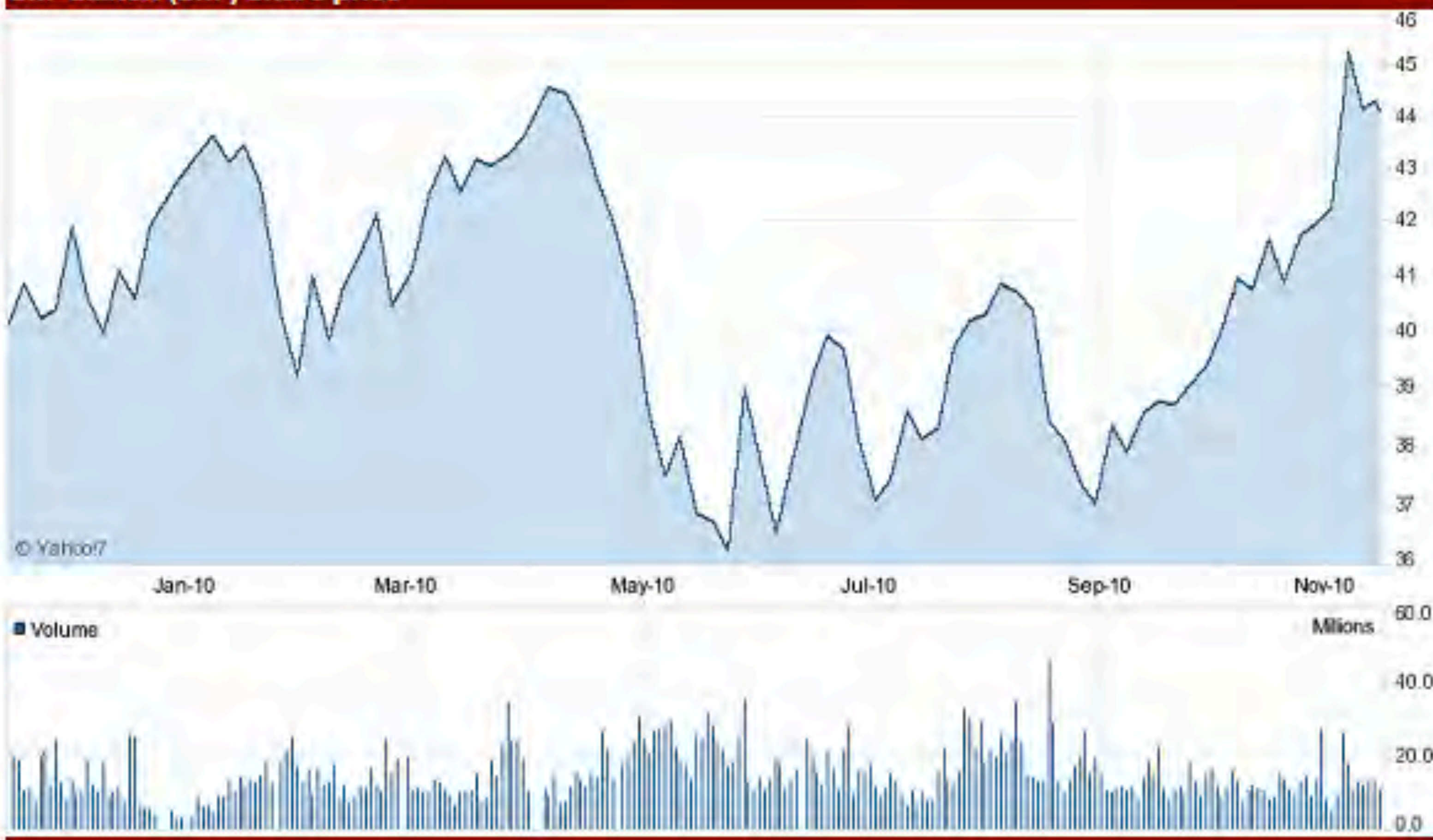
The iron ore example is crude in the extreme, but before anyone criticises the notion, go back to early May, 2007, when analysts at the investment bank Merrill Lynch produced precisely that sort of value-creating break-up suggestion.

What's even more interesting than the 2007 Merrill Lynch claim that a break-up would generate a 34% return for a private equity raider was that its co-author, Vicky Binns, later joined BHP Billiton as head of commodity analysis.

Her argument (with co-author Duncan Hay) was that a variety of options existed to "deliver attractive returns" from a private equity bid for BHP Billiton with a buyout group then dismembering the company for about $US201 billion after paying $US140 billion for the privilege.

The Merrill Lynch break-up scenario might (or might not) have played a part in the sharp share price rise enjoyed by BHP Billiton after it was published, but it is interesting to note that on the day it hit the headlines in 2007 BHP Billiton was trading at $30.60 – on its way to $47 five months later – and $21 in late 2008 during the depths of the global financial crisis.

Binns, still with BHP as a vice president of market analysis, was not the first person to consider breaking up BHP. John O'Connor, a one-time head of BHP Petroleum in the mid-1990s, also hit the headlines with a controversial plan to spin off BHP petroleum



Three seasoned stockmarket observers, contacted by Eureka Report this week to discuss a possible revival of "sum of the parts" investment estimations of BHP Billiton, found the concept intriguing if unlikely.

Warren Edney, senior mining analyst at RBS (Royal Bank of Scotland), said the divisions derived significant synergies from being part of a bigger group, and that BHP Billiton represented a complete package of exposure for investors to the resources sector.

"There's no harm in doing sum-of-the-parts valuations," Edney said. "If you were to put multiples on various pure businesses it would probably give you a substantial increase in the total enterprise value of BHP Billiton. But, having said that it's not something that we're likely to see happen."

Stephen Allen, a director of RFC Group (Resource Finance Corporation), also dismissed the break-up idea but added that BHP Billiton did have a problem with achieving future growth. "When you control so much of the resources world there is a danger of being seen as a commodity-linked bond rather than a growth stock," he said.

Roger Montgomery, a Eureka Report regular, questioned the loss of synergies and the risk of smaller business units receding back to the status of being a commodity "price taker" rather than the power being demonstrated by BHP Billiton as a "price maker".

"The challenge BHP Billiton faces is its ability to re-employ the capital it is generating," Montgomery said.

And that's the key reason why the break-up scenario will re-enter the debate about BHP Billiton, especially if it suffers a fourth failed attempt to secure a big, value-adding, takeover after the rejected Rio Tinto merger, and European Commission knock back for merging its iron ore division with Rio Tinto, and the Canadian Government's refusal to approve the PotashCorp deal.

BHP Billiton rejects any suggestion that it is running out of growth options, or that it will be forced to stop hunting for what it calls tier one assets despite spending about $850 million on its three failures.

At the company's annual meeting in Perth yesterday (November 16) Jac Nasser staunchly defended chief executive Marius Kloppers, saying that takeover bids were board decisions and that the board encouraged Kloppers to chase big deals.

But, it isn't hard to imagine that if the next proposal taken to the board by Kloppers proves as unsuccessful as his first three then a brilliant career might be continued somewhere else.

It will also be a time when analysts start dusting off their "sum of the parts" break-up calculations for a company generating vast amounts of cash looking for a home; in the past that has proved to be an awful time for BHP Billiton shareholders. (It's worth noting that while Nasser was addressing BHP's problems in Perth, Microsoft chief executive Steve Ballmer was addressing that company's AGM and rebutting calls from shareholders to break up the giant computer company.)

Back in the 1990s, when BHP was seeking to grow quickly, it misfired with investments in copper, titanium minerals, value-added iron ore processing and platinum.

Recent earnings estimates from investment banks highlight the potential problem of too much cash and few growth options confronting the BHP Billiton board.

Here's an average of what the analysts are saying about earnings before interest and tax for BHP Billiton's key divisions:

- Petroleum, $US5.2–5.7 billion in 2010-11.
- Base metals (copper), $US6.5–6.7 billion in 2010-11.
- Iron ore, $US12.4–12.8 billion.
- Coking coal, $US3.5–4.2 billion.
- Energy coal, about $US1.4 billion.
- Manganese, about $US1.3 billion.

Each of those divisions, plus BHP Billiton's aluminium, diamond, and nickel operations, could stand alone as separate listed businesses.

The question is whether it makes sense to split them from the parent. The short-term answer, for investors seeking instant gratification, is yes. A fast profit could be generated by creating a series of separate listed, purpose-specific, companies.

The long-term answer is that keeping BHP Billiton as a single entity spreads the cyclical risk of commodity-price fluctuations.

What's not being asked, yet, is whether the single entity structure has in fact become nothing more than a commodity-linked bond with few growth options if BHP Billiton has indeed become too big for its own good, especially in face of government intervention in the market.

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