Building Heaps & Piles At BHP

BY ROGER MONTGOMERY - 20/04/2012

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PORTFOLIO POINT: Given the outlook for Chinese growth and iron ore prices, is it time to cast a critical eye over your BHP holding?

The 2001 merger of BHP Limited and Billiton Plc created the world's largest diversified resource company. The company is also one of the largest in the world by market capitalisation and I would guess one of the longest-held stocks in many investors' portfolios, as well as one of the most likely to have been inherited by superannuants from their parents.

Operationally, the company is nothing like it once was. Seriously underperforming assets and overpriced acquisitions had to be written off in the late 1990s, and since then external candidates including Paul Anderson, Brian Gilbertson, Chip Goodyear and, most recently, Marius Kloppers have taken the top job at the Big Australian. Under their sound stewardship – and the biggest mining boom in history – BHP's share price has risen from less than $10 when the merger was consummated to almost $50 prior to the GFC, and again a year ago. But since then, BHP's share price has crashed 30%.

A year ago, with the share price at its zenith, many analysts were extolling the virtues of BHP. I note one company said their positive view on BHP was due to low-cost and long-life mines, growing production and cost discipline. With demand from China strong, the common refrain of course was – and still is – that the outlook for BHP's products was (and is) bright. Many also went on to add that copper had a strong bullish case over the next two years, and with global consumption outpacing supply and a lack of new high-grade deposits coming into production imminently, the marginal cost of copper was set to rise, which could only be positive for the price. And back in November 2010, some analysts were applying a notional price/earnings multiple of 12 to the EBIT numbers of UBS and Goldman Sachs of $US12.4 billion to $US12.8 billion, to arrive at an independent iron ore business valuation of $US144 billion – roughly the same as the market of the entire conglomerate at that time.

So what has happened?

Well, the copper price is indeed up 13% since March 2010, but BHP's share price languishes. And I wonder whether the talk of new in-the-ground metrics to value iron ore assets is akin to the bubble-talk price/sales and price-per-click ratios being proffered as a new way to value internet companies back in 1999 and early 2000.

BHP's principle revenue drivers are the price of iron ore (for the manufacture of steel), the price of oil and base metal prices (predominantly copper). Emerging economies and their insatiable demand for construction and manufacturing materials has thus far ensured BHP grows its revenues and earnings.

Talk to BHP employees and they'll tell you it's all really quite simple: 'Dig it (iron ore) out of the ground for $33 and sell as much of it as you can (currently the price is $US140/mt)'.

But how much of it can they sell? And at what margin?

China's economic data shows its economy is growing at the slowest pace in recent memory. China's economy expanded at its weakest pace in 2.5 years in the fourth quarter of 2011. Sagging real estate (something I have warned investors here to watch) and export sectors have heralded a sharper slowdown, while triggering pro-growth responses from the government.

Most recently, gross domestic output rose just 2% from the previous quarter, suggesting to some economists that underlying momentum is slowing more rapidly than expected.

Interestingly, the fourth-quarter growth rate was the slowest pace since the second quarter of 2009. And this was when the global economy was emerging from a deep recession. It also marked the fourth straight quarter in which growth had slowed down.

Importantly, recent data shows net exports and property investment subtracting from growth. This latter development is a serious concern for investors in BHP, because the property sector is worth some 13% of total economic output and steel is the primary input for building construction.

Back in March 2010, I wrote: "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.

"...BHP's profitability would be substantially impacted by any speed bumps that emerge from China..."

Annual growth in China's property investment of 12.3% as at December marked a sharp slowdown from November's 20.2% pace. Housing investment dropped precipitously in December, while many property developers are warning 2012 looks worse.

The booming housing market helped drive China's parabolic growth, but the government's attempts to engineer a 'deflation' of the property bubble appear to have had a sharper effect.

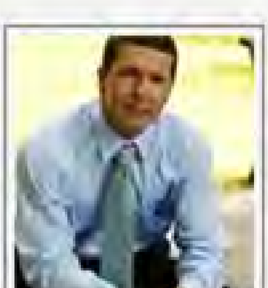
This compounds the adverse impacts on the country's manufacturers and exporters from weakening European export markets, rising labour costs and inflation, as well as the widely reported leadership handover.

If you inherited BHP Billiton (BHP) and/or own it in your superannuation fund, you have to do more than simply keep a close eye on China. If indeed the writing is already on the wall, you need to decide whether you are going to respond.

Skaffold's valuation for BHP has, as I previously predicted, been falling. The 2012 valuation of $36.85 has indeed been leading the share price lower, as Ben Graham might have suggested it would when he explained that in the long run the market is a weighing machine. (BHP is currently trading at about $34.51) For those who are interested, my Rio valuation is $70.62 (Rio is currently trading at about $66.12).

However, my BHP valuation currently rises to $44 for 2014, but I say "currently" because I suspect by 2014 an iron ore supply response will have forced the iron ore price lower, and triggered a raft of earnings revisions that will reduce BHP's valuation.

China may continue to drive GDP with capital and fixed investment spending on fast trains, highways, cities and airports, but irrespective of whether the GDP is 9% or 6%, the proportion of fixed-asset investment cannot be sustained at 60% of GDP. More importantly, the iron ore China does require may be purchased at much lower prices and like the declining margins Apple faces on its new generation iPads, and Gerry Harvey endures on sales of widescreen TVs, BHP may also have to endure lower margins on iron ore while also selling less.



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