The Economist

**BHP Billiton**

# Making the earth move

## BHP Billiton's remarkable growth has been driven by luck, shrewd dealmaking and, above all, China's demand for steel

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Where there's muck, there's copper and zinc

AROUND the turn of the millennium the bosses of Billiton, an ambitious South African mining company, sat in the lobby of a big fund manager waiting to talk up their firm's prospects. At first they were welcomed warmly. But their hosts' smiles turned to frowns when they discovered that the waiting delegation was from a firm in the unfashionable business of mining. They had been expecting a group from lastminute.com, an online travel agent with a seemingly bright future.

In March 2001, after the dotcom boom ran out of puff, Billiton and Broken Hill Proprietary (BHP), an Australian rival, revealed plans to merge. A decade on BHP Billiton is a vast multinational in a business dominated by powerful firms. Its financial might was made apparent on August 17th, when PotashCorp, a Canadian fertiliser firm, rejected a $40 billion unsolicited takeover offer from BHP, calling the bid "grossly inadequate". Earlier this year the firm was instrumental in the opposition to Kevin Rudd, then Australia's prime minister, who was trying to impose a supertax on mining firms (Mr Rudd resigned in June, partly as a result). Its market capitalisation of $190 billion puts it ninth on the list of the world's largest listed companies. And as for lastminute.com, it was snapped up by Sabre, an American travel firm, for just £577m ($1.07 billion) in 2005.

Mining has been a good business in the past few years, thanks largely to China. Once a minor consumer, that country is now hungry for metal to reinforce its office buildings and keep its factories humming. In 2009 China nabbed fully 67% of all internationally traded iron ore.

But BHP has outshone its peers in recent years, as its shares' performance demonstrates (see chart 1). In 2001 the newly merged company was only just bigger than Rio Tinto, an Anglo-Australian miner that is its nearest competitor. Rio's market capitalisation is now less than two-thirds of BHP's. Forecasts suggest that BHP, which reports annual results on August 25th, could make over $12 billion in profits. And if Rio has not kept pace, Anglo American, the world's second-biggest miner before the BHP-Billiton merger, has fared even worse: it is currently less than one-third of BHP's size.


BHP has achieved its dominant position through a combination of luck and good judgment. More than in many other industries, building a mining giant means striking the right deal at the right time. The valuations of mining firms fluctuate greatly along with the prices of the stuff they dig out of the ground, making it easy to overpay for them when times are good. BHP's deals have been more daring and have proved more advantageous than those of its rivals. Oddly, it has done well even out of a deal that failed to come together.

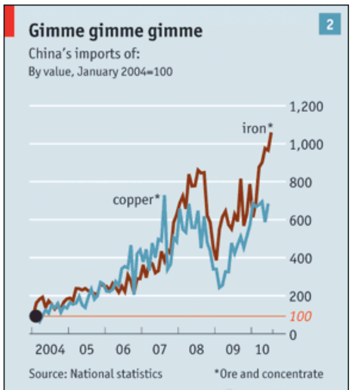
The architects of the merger between BHP and Billiton reckoned most other mining companies had two big faults. First, the incumbents tended to assume that shovel-handed engineers were just the sort of chaps to run big mining companies. In reality they were much better at digging holes in the ground than unearthing returns for their shareholders. Second, most firms were medium-sized and relied on a single commodity to drive profits. Cyclical shifts in demand sent their fortunes swinging wildly. They found it difficult to achieve the consistent investment needed in an industry where ten years can pass between the discovery of a new deposit and a mine reaching full production.

There was an exception. Rio Tinto (which we should disclose was run for much of the 1990s by Sir Robert Wilson, a former chairman of *The Economist*) had set a new model as a large, diversified mining company that could afford the capital outlays needed for the biggest projects. Rio tried to insulate itself from the ebb and flow of commodity prices by acquiring interests in a wide portfolio of metals whose prices would not fall as far or as fast as each other at the same time.

The new company would emulate Rio in this way. It would also follow its competitor by concentrating on assets that were, in mining jargon, "tier one". The merged firm brought together low-cost, easily expandable mines that would remain profitable even when commodity prices were low. And its bosses sought to ensure that any acquisitions were of the same standard.

The model of the diversified mining giant was Rio's but its upstart competitor beat it at its own game. Believing that Rio's pre-eminence had led it to rest on its achievements, BHP set about shedding its low-margin steel and shipping businesses, and began to concentrate on digging. Slimmed down and with money to spare, it began to snap up smaller outfits.

Some of its purchases were risky. In 2005 the firm paid $7 billion, then a big sum for a mining deal, to buy WMC Resources, an Australian company. WMC's most important asset was Olympic Dam, a huge copper and gold mine which is also the world's largest uranium deposit. The deal was widely reckoned a mistake. Conventional wisdom had it that 2005 was the top of the copper market and that commodity prices would soon tumble. In fact China's mountainous demand for the metal had barely reached the foothills (see chart 2).




### A stumble and a courtship

BHP's timing was as good as its rival's proved poor when, two years later, Rio won a desperate bidding battle for Alcan, a Canadian aluminium-maker. Many of Rio's subsequent travails are a result of the enormous debt it took on to outbid America's Alcoa with a knockout $38 billion offer. Alcan is a handy asset—the vast amounts of energy required to smelt aluminium are supplied by reliable, cheap hydroelectricity. But Rio paid too much for it. Confident talk of a "super-cycle" of permanently high commodities prices notwithstanding, demand was about to drop. The deal was a near catastrophe for Rio and a burden which has only recently lifted. The firm has slashed debts from $39 billion to $12 billion over the past year.

A few months after Rio bought Alcan, BHP approached Rio with an audacious takeover bid worth some $135 billion. It was not the first attempt at courtship: Rio and Broken Hill Proprietary had discussed a merger in 1999. But the headwinds were still too strong in 2007. Rio, which had just taken on its current chief executive, Tom Albanese, was loth to entertain an offer from its archrival. The prospect of a commodities powerhouse filled customers with dread. The credit crunch would have made it hard for BHP to service Rio's debts in addition to the ones it would acquire during the takeover. And the recession caused a crash in commodity prices worse than the miners expected.

So the bid flopped, at great cost for BHP. The company paid some $380m in fees for lawyers, bankers and accountants to prepare the putative deal, including the cost of a mammoth $55 billion debt facility to finance it. But the aftermath of the deal turned out worse for its chief competitor.

Still laden with debt from the purchase of Alcan, Rio was beginning to suffer from the economic downdraught by the end of 2008. It also had a big new shareholder in the form of Chinalco, an aluminium firm controlled by the Chinese government. Chinalco had taken a 9% stake in Rio in a dawn raid in February 2008, shortly before BHP made formal its unofficial approach to Rio. The Chinese, petrified of a vast new mining company using its pricing power over the raw materials that the country craved, hoped to use the stake to thwart BHP's advances on Rio.

Meanwhile BHP was emerging from the recession stronger than other miners. Its robust balance-sheet allowed it to maintain investment while other big firms slashed capital expenditure. In 2009 BHP spent $10.9 billion, more than the previous year's spending of $9.5 billion. Rio, in contrast, spent $5.4 billion in 2009, some $4 billion below what it had planned to spend. The steady investment helped BHP keep mines running at peak productivity levels and let it expand some projects.

The world's biggest mining firm soon had another opportunity to deal with its rival. Chinalco offered to invest $20 billion in Rio in early 2009 in a deal that would have given it a share in some mines and seen its stake in the whole company rise to 18%. To the ire of the Chinese, Rio pulled out of the deal. The firm's financial position was improving along with rising commodity prices, and rebellious shareholders were insisting on a conventional rights issue. Instead of taking Chinalco's cash, in June 2009 Rio turned to its suitor of old—BHP.

The timing suited a deal, but this time a joint venture rather than a merger of BHP and Rio. Paul Skinner, an obdurate opponent of BHP's advances, had recently stood down as chairman of Rio. BHP's then chairman, Don Argus, persuaded his new counterpart of the merits of a 50-50 joint venture of the companies' iron-ore operations. After all, crunching together the two firms' enterprises in the Pilbara region in Australia was one of the main reasons that a full merger between BHP and Rio had seemed so attractive.

This deal is still being scrutinised by regulators. The joint venture would produce 350m tonnes of iron a year, more than a third of the total seaborne trade—something that worries steelmakers. By combining rail lines, ports and other infrastructure the pair hope to save some $10 billion.

**From miner to major**

In many respects the proposed joint venture favours BHP. As the smaller partner in the Pilbara, it will pay Rio $5.8 billion to equalise their ownership. A steep rise in iron-ore prices since the end of last year makes that now seem cheap. And Rio has more advanced infrastructure in the Pilbara, including plans for remote-controlled lorries and trains. In June it opened a control centre for these operations in Perth, 1,500km distant from its mines. BHP's Port Hedland, where its ore is transferred to ships, is already operating close to capacity. Expensive plans to build an outer harbour there may no longer be necessary now that the joint venture could choose the cheaper option of extending Rio's port at Cape Lambert.

As well as making bold deals, BHP has shaken up a conservative industry. After the 2001 merger the firm began to attack the layers of management that had built up within it—an almost inevitable result of having to manage diverse, far-flung operations. At one point the company identified 9,000 levels of management authority across its many businesses. BHP still battles with the complexity of running nine business units spread across the world. But it claims to have pruned management to 30 levels and has a group dedicated to stopping the number from rising.

The clearest example of BHP's efforts to change the way miners do business is its role in the demise of the decades-old benchmark system for trading iron ore. For many years iron prices were thrashed out in private negotiations between the world's three big ore producers (BHP, Rio and Vale, a Brazilian firm) and the world's leading steelmakers. The result was an agreement for all steelmakers to pay the same prices for the whole year.

Marius Kloppers, BHP's chief executive, led a campaign to introduce a more flexible system. For many years prices had been low and stable but the arrival of China as a big buyer had led to huge annual increases. If spot prices rose over the course of a year miners could not take advantage until the next round of negotiations. In contrast, when prices fell in 2008 the benchmark system offered steelmakers a free option to abandon contracts and buy on the spot market. That frustrated the miners.

For their part, Chinese officials had gradually come to believe equally firmly that miners were asking too high a price for their ore. As a result, negotiations with the country had become increasingly protracted and difficult. Last year, after months of discussions, China's negotiators failed to reach an agreement with the miners. Rio and Vale were still reluctant to change the system. But earlier this year, after another round of difficult negotiations with China, both companies came round to BHP's way of thinking. Iron ore is now sold on quarterly contracts at a price closely linked to spot markets.

This new price-setting system may help BHP in another way. The wary regulators who are scrutinising its proposed joint venture with Rio may look more favourably on a firm that helped do away with a somewhat secretive system of annual price-bargaining.

In all, BHP's smart dealmaking has made it not just the biggest but the most influential and the best-positioned of the big mining firms. Alongside its interests in iron ore, coal and a host of metals it owns a large oil and gas business. Last year this contributed a fifth of profits. It provides an extra layer of diversity and a hedge against volatile prices in an industry that is a heavy user of energy. Vedanta, a big Indian miner, is following BHP's example. On August 16th it said that it would pay close to $10 billion to buy control of the Indian oilfields of Britain's Cairn Energy.

The Chinese economy is now growing at a rapid clip—it is forecast to expand by 10% this year. That leaves BHP and its rivals facing a question and a danger. The pleasant question is what to do with their cash. Other miners also regaining decent financial health are on the lookout for the big deals that bring scale and greater diversification. Earlier this year Xstrata, a relative newcomer to the business which has rapidly grown to the size of Anglo American through a series of takeovers, attempted to persuade Anglo to join it in a nil-premium merger. The offer was smartly rebuffed by Anglo's board.

**Not such a big deal?**

Xstrata's response to the brush-off hints at how much has changed in the mining business in the past few years. The firm's boss, Mick Davis, who had helped orchestrate the BHP merger when he was an executive at Billiton, announced that his company was henceforth likely to grow organically. For a company that has expanded through the cut-and-thrust of dealmaking this is a significant reversal. Few believe that Mr Davis will eschew deals altogether (he may yet try his luck again with Anglo) but his statement hints at the scarcity of plausible takeover targets. There are, indeed, few firms left that are big enough to interest mining giants like BHP and Rio.

And what of diversification, the goal of many big miners in the past decade? BHP's offer for PotashCorp suggests the firm is still pursuing it. Agriculture is a fairly reliable industry and demand for potash-based fertilisers ought to grow along with demand for meat in developing countries: both China and India are huge importers of the stuff. But there are other signs that diversification is falling from favour in mining circles. In May Vale, which itself tried and failed to land Xstrata around the time that BHP pursued Rio, sold its aluminium business to Norway's Norsk Hydro. Although Vale will keep some exposure to the metal by retaining a 22% stake in Hydro, the sale challenges the mega-miners' orthodoxy of spreading their eggs between various baskets.

The reason for the change is that, in effect, the mining firms' eggs are all in a new basket—not a single product this time but a single country. So dependent are they on Chinese demand that even a diversified portfolio may not be much of a defence against a downturn. BHP is also becoming more dependent on the steelmakers. The proportion of its revenues that come from iron ore, metallurgical coal and stainless-steel ingredients rose from 34% in 2007 to 39% in

2009. The company is handily positioned to benefit from China's growth, which is heavily dependent on steel. But it also poses a greater risk should China's economy, and particularly the steel-skeletoned property market, wobble.

By making a large offer for PotashCorp, BHP has given a clear indication of where it intends to deploy the considerable financial firepower its success has brought. But success on that front is not guaranteed: PotashCorp seems determined to remain independent. Another possibility is that Rio will pull out of the planned iron-ore joint venture if regulators impose too many conditions. That would clear the way for Mr Kloppers to set his sights on a full takeover again. As Andrew Keen of HSBC points out, if Rio was attractive to BHP when it had debts of $40 billion why would it not be now?

As the benefits of diversification ebb, the benefits of scale are growing. Vast size and the power it confers might be one way to counterbalance the miners' dependence on China. BHP's efforts to acquire Rio might, like the mining business itself, turn out to be cyclical.

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