FINANCIAL REVIEW

SE Companies and Markets

HD **Vale fails in bid for diversity**

BY Matthew Stevens
WC 1,197 words
PD 4 December 2014
SN The Australian Financial Review
SC AFNR
ED First
PG 32
LA English

LP

Matthew Stevens

Vale's decision to retreat to its **iron** roots in Brazil represents a dramatic shift in the geopolitics of the mega-miners as much as it does acceptance that an expensive, boom-time pitch for diversity has well and truly failed.

TD

Still uncertain, preparations to spin out the Brazilian **mining** champion's base metals complex could relieve Vale of a world of pain and complication and see its ambitions trimmed to its host continent.

Whether by plan or satisfying coincidence, this fits hand in glove with the ambitions of Vale's biggest shareholder, the state of Brazil.

The government sacked Vale's great internationalist, Roger Angelli, in 2011 after the chief executive appeared to thoroughly ignore encouragement to focus more productively on South American opportunities, rather than pursue further foreign campaigns.

Vale, of course, is still majority owned by the government. So what it wants matters.

Pretty much from the moment Angelli was shunted, the structural separation of Vale seemed a live option. And the fact that Vale has confirmed a potential divorce, as we arrive at what feels like a new low point in the commodities cycle, only reinforces that perceived inevitability.

Quite naturally, Vale's reassessment of its base metals business will be seen through the same lens as BHP Billiton's decision to package up its sub-scale businesses and deliver it to existing shareholders.

But this idea is less valid than it might at first glance seem.

Vale says the review of base metals is about recovering the slimline fitness necessary to sustain and grow through the marathon that will be the future of its core business, **iron ore**. BHP's motivation is very different, though the outcome seems the same.

SpinCo is made from commodity silos that will only grow outside of the newly concentrated BHP family. The SpinCo names contribute just more than 5 per cent of BHP's profit, and they barely justify the sustaining capital they require, given the Global Australian's core four generate internal rates of return on capital of better than 25 per cent.

Effectively, SpinCo eats capital and management time without adding anything like the equivalent benefit.

In contrast, Vale's base metals business pretty much represents all of its global aspirations and, over the most recent quarter, the group currently generates almost a third of the group's top-line earnings.

In short, BHP's pruning leaves its basic strategy unchanged, while Vale's review sets the scene for a very new era indeed.Asset sell-offs

The other point of perceived concert between the Vale and BHP initiatives is that new management is selling off assets acquired in unnecessary and failed mergers.

No doubt, the mass of SpinCo's assets arrived with BHP's merger with Billiton in 2000, while the bulk of Vale's base metal business came with its takeover of Inco. But, again, first glances deceive.

Debate over the cost of BHP's alliance with Billiton continues to rage. But it misses the point because it starts from the wrong place.

The right question to ask is whether BHP is a better business because of the merger? The only answer to that is yes.

Billiton very quickly transformed BHP from a business unable to afford to pay a dividend (for that was the prospect in 2000) into one able to ride the cycle and emerge as the world's biggest diversified miner.

Vale, on the other hand, was left in a state of confused stasis by the Inco deal, and the complications of capital allocation, culture and management it created.

When Vale paid $US18.9 **billion** ($22.3 **billion**) for Canada's second-biggest **company** back in October 2006, the Brazilian was by a healthy distance the world's biggest **iron ore** producer. Then, Vale produced just more than 300 **million** tonnes a year of **iron ore**. Its two Australian competitors, Rio Tinto and BHP Billiton, added another 230 **million** tonnes to the system.

Over the next eight years while Vale sat in a time warp, increasing production to only 350 **million** tonnes a year, the Australians seized the day.

Today, Australia exports 700 **million** tonnes a year to global steel makers, with Rio saying it is headed to 360 **million** tonnes a year, and BHP convinced that its most productive course takes it to 290 **million** tonnes annually.

Oh and let's not forget the third force, Fortescue, which is currently running well above its 155 **million** tonne production target. Vale's investments

Instead of pressing the pedal on growth, Vale concentrated on reducing the cost of getting its material to market.

It invested against a fleet of massive boats called the Valemax to trim shipping costs, only to have them banned from entering **Chinese** ports.

So it is that, as its base metals divestment was confirmed a possibility, Vale was cutting the ribbon on a new $US1.4 **billion iron ore** port in Malaysia. Built to receive 400,000 tonne Valemax boats, it will be Vale's new regional hub.

But, however you cut it, and for whatever reason, the net result of Vale's experiment in growth through **acquisition** has been that the core business is weaker, and now head office has decided that it does not want to carry the weight of a highly complicated set of nickel and **copper** businesses.

The worrying risk for Vale is that while the seaborne **iron ore** trade stays in surplus, it is the marginal producer.

There must be delicious irony in this for Australian operators with long memories.

Brazil's stunningly rapid rise in the early 1970s to pre-eminence in the **iron ore** business was built by the Japanese steel mill's determination to foster competition and their understandable concerns over Australia's growing unreliability.

Now, with the markets in surplus and Australian producers driving their costs ever lower, while running their systems at world class reliability, Vale has been left the most vulnerable of **iron ore**'s majors to the potential demand shock ahead.

News that US **oil** services king-pin Schlumberger had taken the **lead** in big **oil**'s response to market calamity by taking a $US800 **million** write-down on its offshore exploration fleet will likely also resonate around BHP Billiton.

Schlumberger is BHP's driller of choice in the US shale game. And according to some inspired computing by Deutsche Bank, the contractor might be headed for some onshore pain as well.

At current prices, the DB model says BHP's Permian wells would not be making their cost of capital and those in the more established Black Hawk would be generating only a 20 per cent internal rate of return.

The model also says that, if **oil** prices continue to orbit $65, BHP's shale business risks missing its target to be cash flow positive by 2018.

Wryly, DB offered an answer. Current high US gas prices suggest a return to the dry gas at Haynesville and Fayetteville could be a better short term growth option.

The Fayetteville, of course, was recently added to BHP's list of potential disposals.

CO cvrd : Vale S.A.

IN i211 : Metal Ore Mining | i2111 : Iron Ore Mining | ibasicm : Basic Materials/Resources | imet : Mining/Quarrying

RE austr : Australia | apacz : Asia Pacific | ausnz : Australia/Oceania

PUB Fairfax Media Management Pty Limited

AN Document AFNR000020141203eac40002p