HD **Asian Trader: Mining Pick? Take Rio Tinto Over BHP Billiton -- Barron's**

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By Assif Shameen

For most investors, the mining sector has been a house of pain in the last year. Oversupply amid falling demand from China, the world's largest market for raw materials, has prompted the sector's woes. The big miners' problems have been exacerbated by their exposure to a single weak commodity: iron ore. Shares of the Australian giant BHP Billiton are down 30% in the past four months and over 40% from their 2011 peak. Rival Rio Tinto Group's stock is down 35% from its peak three years ago. Both have extensive global mining operations.

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"Though mining is not a sector for investors with little appetite for risk, we are at levels now where there is clearly money to be made," says Paul Gait, analyst for Sanford C. Bernstein in London. When investors ask him if they might end up catching a falling knife, Gait tells them they shouldn't wait much longer if they want to participate fully in the upside.

Adds Paul McTaggart of Credit Suisse: "The problems of miners are so well known that almost all of the bad news is already in the price." The stocks, notes the Sydney-based analyst, "tend to overshoot on the way down because investors don't know where the floor is."

Rio Tinto (ticker: RIO), which has a market valuation of $85 billion, seems like the better bet. BHP (BHP) gets about 30% of its roughly $73 billion in annual revenue from oil, notes McTaggart. As a result, "the real worry is that oil prices could fall even lower, which puts question markets around BHP," he says. What's more, 55% of BHP's oil comes from shale, where it's invested heavily in recent years. The balance comes from traditional fields. Unfortunately for BHP, it can produce a barrel of oil from the conventional sources for $25 while the shale-generated version costs roughly $50 a barrel. As the price of oil falls, the shale production starts to drop toward break-even. BHP also continues to invest in shale, where it's estimated the company is spending about $4 billion a year.

In contrast, Rio and other miners become more profitable as oil prices fall because their costs for diesel fuel drop. "Oil makes up between 20% to 25% of most miners' total cost base," so a price drop is a substantial benefit, says McTaggart. It costs Rio $20 to $25 to produce a ton of iron ore, with diesel costs accounting for $5 a ton. A 30% fall in diesel price means Rio's production costs go down by roughly $1.50 a ton.

Moreover, lower oil prices should spur additional global growth, which presumably translates into better worldwide demand for raw materials.

Though its price is down 47% this year, iron ore has begun to stabilize at around $70 a ton in recent weeks. At that price, it's still an immensely profitable business for Rio. "Sure, prices have come down from $180 to $70, but their $25 production cost means Rio is making money hand over fist," says McTaggart. "Why would anyone in his right mind shut down capacity or sell parts of their iron-ore business with such high margins?"

Rio is expected to report $9.6 billion in net income and $5.23 per share in earnings this year, down 5.2% and 5.4%, respectively, from the previous year. BHP is forecast to post $11.3 billion in net income and $2.25 per share in its current fiscal year, ending next June, down 10.2% and 10.1%, respectively.

Both BHP and Rio have slashed costs in the last year, reducing their capital expenditures and putting some of their noncore assets up for sale to boost efficiency. They could do a lot more. Rio tried to sell its diamond business last year but withdrew the offer because it didn't get the price it wanted. If the commodities downturn is prolonged, it may look to put that unit back on the block. It also tried unsuccessfully to sell its Australian and New Zealand aluminium businesses; with that market improving, analysts say Rio may be ready to revisit a sale. Rio also tried to sell its U.S. industrial minerals unit a couple of years ago but couldn't get a good price.

For its part, BHP, which has a $134 billion market-cap, has been more proactive in asset sales. It is spinning off some noncore assets, including metals and minerals such as silver, lead, manganese ore, and alumina. It reportedly tried to do a deal with Glencore Xstrata on the sale of its nickel assets, but the sale fell through.

Not everyone thinks that selling assets is the right strategy. "Rio and BHP are still generating enough cash, so they really don't have to do anything unless things get much, much worse," says Gait. "BHP's balance sheet isn't actually that geared, so there is no real necessity to sell assets to repair it," he argues. He'd prefer the company, which prides itself on its management skill, try to fix the businesses.

Investors in either stock are being paid to wait for a turnaround in commodity prices, since the two miners sport attractive dividend yields. Rio is clearly the preferred play among analysts, based on the recent direction of oil prices. Credit Suisse's McTaggart has a Buy on Rio with a price target of 67.50 Australian dollars (US$56.12), 18% above its recent level. The stock trades at 8.8 times current-year earnings, with a 4.8% dividend yield.

"The worst is behind for Rio, and I really think we are close to the bottom if we haven't actually hit bottom," says McTaggart.

Assif Shameen covers Asian markets from Singapore.

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