THE WALL STREET JOURNAL.
ASIA EDITION

HD Heard on the Street / Financial Analysis and Commentary

WC 1,088 words

PD 14 February 2014

SN The Wall Street Journal Asia

SC AWSJ

PG 28

LA English

LP

China Trusts' Road to Bust

Sooner or later, someone in China's trust-products universe is going to lose real money.

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Weeks after a hasty bailout was arranged for a troubled Chinese trust product, another shadow lender, Jilin Trust, has failed to make payments on tranches of an investment product that came due over the past few months. Jilin is set to miss another payment next week. Once again the product in question is linked to a troubled coal miner, and was sold to investors by one of China's big four state banks, in this case China Construction Bank.

The product's six tranches amount to nearly one billion yuan, or around $165 million, smaller than the $500 million worth of ICBC-sold products rescued last month by a mysterious third party. Trust investors in that case lost interest payments but no principal. Another shadowy resolution in which investors eventually get their principal back can't be ruled out. Jilin Trust told investors the coal company is in restructuring as it attempts to pay back debt. The final tranche matures in March.

It is also possible authorities will let investors take a bigger hit. Even if not, more distressed trust situations are inevitable and will test Beijing's resolve. Bernstein Research estimates that about 40% of the about 10 trillion yuan in trust products outstanding will mature this year. The trust companies themselves are thinly capitalized, with an equity base equivalent to 2.6% of assets under management. A feedback loop could form: Investors steer clear of new trust products, and trust companies are then unable to roll over old loans to stressed borrowers, causing more defaults.

China's big banks will be insulated so long as they can hold the line that they aren't liable for failed products that they distributed. If banks are seen to be involved in a bailout, investors will be right to question how much of this off-balance-sheet activity needs to be accounted for on the books.

In theory, China's trusts are economically useful, directing credit to dynamic companies that banks don't reach because of their bias toward serving other state-owned enterprises.

In practice, trusts tend to be lenders of last resort to the least-productive sectors that the banks have been told to avoid. The China Trustee Association says 35% of trust assets are invested in the infrastructure, energy, mining and real-estate sectors. Nomura economist Zhiwei Zhang reckons the true proportion is over 50%.

The good news is Chinese investors are getting reacquainted with risk. The question is whether this can happen without sparking a broader crisis of confidence.

-- Aaron Back

Recovery at Rio's Tinto

Is Built on Pumping Iron

Rio Tinto is digging deep. With investors clamoring for lower costs, improving cash flows, reduced spending on grandiose investment projects and higher payouts to shareholders, the Anglo-Australian miner shoveled up the goods Thursday.

That makes Rio a good bet on a recovery of the mining sector -- if the price for iron ore holds up.

Rio has cut operating costs by $2.3 billion and should easily hit its $3 billion target by the end of 2014. Capital expenditure is expected to fall to $11 billion this year and $8 billion in 2015 from $12.9 billion last year. Record volumes in Rio's high-quality, low-cost iron-ore operations helped operating cash flow rise 22% in 2013 from the prior year.

Despite that, Rio's net cash flow after tax, at $15.1 billion, didn't cover its capital investment and $3.3 billion paid in dividends in 2013. But a 15% hike in Rio's dividend is a sign of confidence that free cash flow will continue improving. Net debt, at $18.1 billion, is nearing Rio's midteens target.

The company, then, seems well placed to ramp up share buybacks or special payouts to shareholders next year. And Rio looks cheap. At about nine times 2014 earnings, at Jefferies forecasts, the miner is trading close to one-fifth below the average multiple for the sector.

That discount, however, reflects the fact that Rio remains particularly sensitive to steel production in China. Earnings in Rio's aluminum business increased more than tenfold last year; copper production is ramping up. But iron ore, an ingredient in steelmaking, accounts for close to 90% of the company's divisional earnings.

A tightening of Chinese lending conditions, as well as the government's heightened focus on air pollution, adds to the usual angst over the outlook for economic growth. Iron ore has already fallen from a peak of close to $140 a ton late last year to about $120.

And each $10 decline in the iron-ore price could knock perhaps $1.7 billion from Rio's free cash flow. Investors have built the prospect of some additional decline into expectations for Rio. But if the iron-ore price goes below more bearish outlooks, say well below $100 a ton, that could jeopardize potential payouts investors are hoping for.

Rio's judicious management could offset that: A somewhat conservative outlook on production for 2014 suggests chief Sam Walsh won't simply ship tons into an oversupplied market. But Rio has outperformed its peers since the sector's lows last year. China and iron ore could still test investors' metal.

-- Helen Thomas

Overheard

It has yet to rival the influence of the Trade Federation in "Star Wars" but the so-called Federation at Goldman Sachs is gaining power.

The firm announced Tuesday five new members for its management committee, heralding a subtle shift in its composition. Previously, the committee was about equally divided between sales and trading, investment banking and the Federation. This is the firm's nickname for non-revenue-generating units that, at other firms, might be derisively called "the back office." At Goldman, they are very powerful, spanning areas such as legal, accounting, risk, compliance and "human capital." The addition of Craig Broderick, chief risk officer, and Sarah Smith, chief accounting officer, means there are roughly more people from the Federation on the committee than from investment banking. Three people also were added from sales and trading, making that group larger than the Federation. Investment banking now trails both.

Goldman's Federation shouldn't get too full of itself, though. Unlike the Federation in "Star Wars" it is unlikely to gain an army of battle droids.

CO rtz : Rio Tinto PLC | craaus : Rio Tinto Ltd

IN i211 : Metal Ore Mining | i814 : Banking | iinv : Investing/Securities | imet : Mining/Quarrying | ibnk : Banking/Credit | ibasicm : Basic Materials/Resources | ifinal : Financial Services

NS c151 : Earnings | c1521 : Analyst Comments/Recommendations | c173 : Financing Agreements | ccat : Corporate/Industrial News | ceffic : Corporate Process Redesign | m11 : Equity Markets | mirono : Iron Ore Markets | ndj : Dow Jones Top Stories | nedc : Commentaries/Opinions | neqac : Equities Asset Class News | nhrd : Heard on the Street | nsum : News Digests | ntesi : Essential Stock Market Information | ntop : Top Wire News | c11 : Plans/Strategy | c15 : Performance | c152 : Earnings Projections | c17 : Funding/Capital | m14 : Commodity Markets | m142 : Metals Markets | mcat : Commodity/Financial Market News | ncat : Content Types | nfact : Factiva Filters | nfce : FC&E

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