Rio Tinto

RIO

August 17, 2010 FAT-AUS-487	AUD$71.00	Core	MED	B

RIO Snapshot +

Stand and deliver! And Rio did

1H10 was a strong start to the year with RIO reporting earnings ahead of consensus. The company reported US$5.8 billion against an expected US$5.5 billion. The strong result was due to higher exports of iron ore at higher prices and a much higher price for copper. The LME price of copper in 1Q10 was 111% higher than 1Q09, and 2Q10 price was 51% higher than a year ago. The Iron Ore business delivered a profit of US$4.1 billion and Copper US$1.1 billion. Rio's proposed internal buyback of the 'Ltd' company shares will occur in two tranches, the first costing around $9.2 billion.

The market was pleased with the strong result and over recent trading days the company has outperformed the ASX 200 share index. This is certainly not the time to take any profits in Rio but rather the time to hold tight for the duration of the business cycle.

Turning to the charts, RIO touched a recent high of $74.22 on August 9, which also saw the overbought signal touched on the relative strength index (RSI). As evident from the daily chart, RIO has since retraced lower finding solid support at the 50 period moving average (green line) at $69.27. Immediate resistance lies at the 200 period moving average (red line) at $71.45. A convincing break of the level would result in a boost of upside momentum and a continuation of the uptrend in place since May.

From a broader perspective, the weekly chart reveals the speed and depth of the decline during 2008, which found support around the $29.00 – $30.50 region. Since then an upward trend has emerged, which saw RIO surge towards the 38.2% Fibonacci retracement level of around the $78.63 – $79.00 region before encountering resistance. The recent pullback found firm support at the 23.6% Fibonacci level at $60.46. Although this move clearly interrupted the upward trend, a sustainable recovery is potentially underway.

The turnaround in profit from 1H09 was more than three-fold and even the Aluminium division moved from making a loss to making a profit.

1H09 wore the brunt of the GFC when Iron Ore made a profit of US$1.93 billion. The very strong performance of iron ore is a major factor driving strategy. Not only is Rio planning to spend US$10 billion to expand its iron ore operations in Western Australia, but it has committed itself to a joint venture with Chinalco to develop the Simandou project in Guinea. Guinea has been compared to the Pilbara but it is not just new projects in Africa that will weigh on supply, but projects in Greenland and Saudi Arabia, not to mention growing Brazil's export capacity.

One might think that Rio's management might have learned a lesson from buying assets at the top of the market, and perhaps they have. But has management learned anything from history like the oversupply of coal in the 1980s?

In late 1979 the price of black coal in real terms was at similar levels to 2010. Japanese and South Korean steel mills and power generators invested heavily in Australia's coal industry in the 1980s. Supply shot up and the price of coal fell heavily and took over 20 years to recover.

The global iron ore industry looks set to repeat Australia's coal experience of the 1980s. An undisciplined increase in supply is going to weigh heavily on the price of iron ore in the long term, perhaps not for five years, but it will happen.

Over the next six years, Rio will expand production from its Pilbara mines to 330 million tonnes. The 105 million tonnes per annum increase in capacity will begin with a capital expenditure program of US$790 million to expand port capacity at Cape Lambert from 80 million tonnes per year to 180 million tonnes per year.

The Simandou hematite deposit in Guinea is a whopper. The target is between 8 and 11 billion tonnes of hematite grading 65% iron. A deposit of this size is capable of huge annual production limited only by spending on investment in new infrastructure. The concept is to begin production at around 70 million tonnes per year and gradually build output to nearly 200 million tonnes per year.

Rio has already committed US$145 million to the feasibility to develop Simandou and another US$44 million will be spent on road and other infrastructure. The total capital cost is expected to be around US$6 billion.

It is easy to understand Chinalco's interest in Simandou as a joint venture partner. Plus it helps make up for a loss of face when Rio rejected Chinalco's previous overtures to take a great big stake in the company. Members might recall that Rio decided on a merger deal with BHP concerning the domestic iron ore assets rather than sell a large chunk of the company to Chinalco.

Rio does not have to do a deal with BHP in the Pilbara. The company is going to create plenty of value for its shareholders on its own merit. The Chinese are conspicuously desperate for energy and copper. We have no doubt that the Simandou JV with Chinalco is just a starting point and that this Sate-owned Chinese company will extend its tentacles to other projects like Oyu Tolgoi. The Chinese are going to get what they wanted but via a different route.

When it comes to sharing project risk for big multibillion dollar resource projects, the Chinese are the only game in town. The Bund in Shanghai has what London and New York would like to have and that's lots and lots of cash. Chinalco will make a good partner for Rio and we would expect to see the bonds between the two companies grow; a win-win situation all round.

Rio Tinto is a compelling story on the basis of its valuation metrics. The consensus forecas reveal that the stock continues to trade on low earnings multiples. The company is trading on a price earnings ratio (PER) of around 9.2X for 2010 and 8.1X for 2011. The respective cash flow ratios are 7.5X and 6.2X.

The consensus PERs for the large cap diversified miners are PERs of around 11.5X for 2010 and 8.5X for 2011. The respective cash flow ratios are 7.5X and 6.0X.

Rio Tinto is still being punished for its misadventure in buying Alcan at the top of the market which weighed the company down with debt. The balance sheet is being repaired and so long as the aluminium division holds its head above water all will be forgotten as investors focus on expanding the Iron Ore Division.

Buyback

The 2010 AGM approved the buyback of all the ordinary shares of Rio Tinto Ltd held by Rio Tinto plc. Rio has now decided to enact the buyback in two tranches, the first commencing this month is expected to cost up to US$9.2 billion. The remainder will be bought back later in the year.

At this point in time there is nothing that leads us to believe that there will be a double dip global recession.

We are now recommending Rio Tinto as a BUY at $71.00 per share.

Guangzhou Automotive, Heineken, Harmony Gold, Hufvudstaden, Icade, Industrial Logistics Properties Trust, Inmobiliaria Colonial Intu Properties, Japa Airport Terminal, Land Securities Group, Meituan Dianping, MGM China, Mitsui Fudosan Co, National Storage, Nintendo, Office properties income Trust Prologis, Retail Value, Sands China, Segro, Seritage Growth Properties, Site centres Corp, SMC Corp, Sony, SPDR Gold Trust, Spirit Reality Capital, Sumitomo Mitsui Financial, Tanger Factory Trust, Taubman Centres, Tencent, Vail Resorts, VanEck Vectors Gold Miners ETF, VanEck Vectors Junior Gold Miners ETF, Vereit, Vodafone, Vonovia, Vornado Reality, Trust, Walt Disney, Wharf Real Estate Investment Co, Wynn Macau, Wynn Resorts, Zillow, ZOZO. These may change without notice and should not be taken as recommendations.