# Rio Tinto

RIO

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RIO Snapshot +

## A world class diversified miner

Rio Tinto is a world-class mining company, with a dual listing in the United Kingdom and Australia. It is one of the world's largest diversified miners, with major exposures to copper, iron ore, coal, aluminium, mineral sands, borax, diamonds and gold. Rio is one of the largest single producers of copper, iron ore and thermal coal. Rio has announced a solid production result for the June quarter, with strong performances pretty much across the board.

RIO has been in a long-term upward trend for the best part of two decades. In the past three years, a strengthening of investor support has seen prices accelerate sharply. From a correction low of $27.99 in July 2003, RIO appreciated nearly 215% to post an all-time high of $88.10 in May.

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After such an extensive rally, it is not surprising to see that the upward trend in RIO has paused for consolidation over the past two months. This is a typical part of the price cycle and does not compromise the longer-term upward trend, in our opinion.

In the near term, we believe RIO will continue to consolidate. Downside risks are limited with initial support between $69.90 and $69.11. Below here, we believe the March low of $67.28 underpins the shares.

A clear break above $79.42 will signal a renewal of longer-term upward momentum. Such move would provide a boost to investor sentiment and target a retest of the $88.10 all-time high.

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Fat Prophets maintains a positive long-term outlook for commodity markets. While a period of consolidation is now occurring in the wake of strong gains, we believe further gains are likely in coming months. Given this positive backdrop and the strength of the long-term upward trend, we believe RIO will, in time, reach new all-time highs above $88.10.

Rio's operations are typically world-class in size and are generally open-cut mines that operate in the lowest quartile in terms of operating costs. Its operations span both North and South America, Australia, Indonesia, Europe and southern Africa.

Rio has a tremendous track record in terms of the consistency of its earnings over time. Its management is first class and the company has a proven record with regard to earnings sustainability. It typically looks to operate in those commodities and markets where it can exert some degree of pricing control.

It has consistently demonstrated a high level of operating margins and cash flow, along with superior rates of return. The company employs a zero hedging policy on both commodities and currencies.

Rio Tinto has announced a solid production result for the June quarter, with strong performances pretty much across the board. The highlight was the strong recovery in production from the iron ore division, impacted during the previous period by cyclonic conditions in Western Australia. The result ensures Rio continues to optimize its exposure to the current strong commodity price environment.

Broadly speaking, all divisions performed better than expected. The highlights were iron ore, alumina, gold and US coal. The only weak link in our view was uranium, as well as a softer production outlook over the next two years for gold and copper.

Iron ore production was a record for the quarter at 23 million tonnes, up 4% compared to same period last year and a substantial 16% compared to the previous quarter. Bad cyclonic weather in Western Australia hampered production during the March quarter and to some degree the initial few weeks of the June quarter. Nevertheless, the June quarter result is a strong one and shows that the significant output expansion program in on track.

We anticipate an even stronger result during the current quarter. Rio has commented that global iron ore demand remains strong in all markets. It recently negotiated a 19% increase in benchmark prices from Western Australia for the 2006 contract year, while its subsidiary Iron Ore Company of Canada received a 17.3% increase.

On the development front, construction of the US$1 billion Hope Downs iron ore project in Western Australia (Rio's stake US$685 million) began in April.

Coal was another strong performer, with US thermal production achieving record levels during the quarter. Production was up 10% compared to the same period last year and up 7% compared to the previous quarter at 31.7 million tonnes. This was in line with the recovery in rail capacity and the expansion of the Spring Creek and Antelope mines. Antelope and Spring Creek in fact saw new quarterly production records, with the expansion projects at both mines encouragingly progressing ahead of schedule.

Australian coal production also recovered strongly from the previous quarter, with hard coking coal production up 36% to 1.5 million tonnes and production of other coal types up 6% to 8.1 million tonnes. Production from the Hunter Valley in New South Wales was in line with expectations according to the port allocation at Port Waratah.

Rio's aluminium division also performed well, with alumina production up 10% compared to the previous quarter and the same period last year at 854,000 tonnes. The Comalco refinery in the Northern Territory recorded an outstanding performance, with production 25% above the previous record quarter. There will however be a major shutdown during the current quarter that will impact production. Bauxite (the feedstock for alumina production) output was also up by 4% compared to the same period last year.

Copper mined was up 2% compared to the previous quarter and up 9% compared with the same period last year. This was primarily due to higher-grade ore at Kennecott in the USA and Escondida in Chile. At Kennecott, copper minded was up 21% compared to the same period last year and 11% compared to the previous quarter, while at Escondida production was up 12% on the same period last year and down 1% on the previous quarter.

Refined copper and gold production rose strongly during the quarter to 67,700 tonnes and 141,000 ounces respectively. Copper production was up 63% on a year ago, while gold production was up 85%.

The only weak link in the copper-gold division is Grasberg in Indonesia, where production of 10,200 tonnes of copper and 19,000 ounces of gold was down significantly on the same period last year.

The performance of the industrial minerals division was sound, with titanium dioxide feedstock production 3% above the previous quarter and 8% above the same period last year. This reflects the strength of customer demand and further expansion upgrades. Diamond production was also solid with Argyle in Western Australia and Diavik in Canada boasting production 44% and 52% respectively above that of the previous quarter.

The overall outlook for Rio Tinto is sound. We anticipate that it will generate around at least one-third of its earnings over the next 12 months from its iron ore division, where higher earnings are 'locked in' due to the recent contract price negotiations. We also expect Rio to generate around 40% of its earnings from copper, where prices are also performing strongly.

Rio Tinto therefore offers strong exposure to the ongoing commodities bull market, whilst at the same time the diversity of its earnings base, its strong balance sheet and low P/E ratio, reduces the level of risk for investors. We expect Rio Tinto to trade on a modest forecast Price/Earnings (P/E) Ratio of around eight times for at least the next two years, which underlines its attraction, along with a fully-franked yield of around 4%.

In addition to an attractive valuation, Rio has a strong pipeline of new projects that will underpin growth for several years, as well as an aggressive exploration program. We also believe Rio's earnings could surprise on the upside due to commodity price strength. It is an obvious alternative for those Members looking for a diversified resource investment but without exposure to the oil sector.

**We recommend Rio Tinto as a Buy to all Members around $73.50.**