Rio Tinto

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Riding the commodities boom

As Members will know, we have long held a bullish view on commodity prices. In our opinion, the resource sector will continue to enjoy above average returns over the next five years, with many commodities now in what we believe to be a super cycle. As a result of industrialisation in China and India (among other nations), the world is facing a massive shortage in raw materials for years to come.

We believe mining heavyweight Rio Tinto (RIO) offers excellent leverage to the ongoing commodities boom. Major products include iron ore, copper, aluminium, diamonds, energy, gold, and industrial minerals. Rio has particularly high exposure to iron ore and copper which respectively account for around 32 and 38 percent of earnings.
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We expect ongoing strength in the price of both key commodities. China appears to be backing away from attempts to lower iron ore prices, raising expectations of a double-digit increase in 2006-07. While copper prices have surged to record levels, the outlook remains robust, with global supplies remaining tight.

Rio's origins date back to 1873 when a company was set up to take over the Spanish government's copper mines at Rio Tinto. The group's modern form came as a result of the 1995 merger of Rio Tinto Limited, (formerly Conzinc Riotinto of Australia) and Rio Tinto plc (formerly Rio Tinto-Zinc Corporation). The dual listed (on the ASX and LSE respectively) companies are managed as a single economic unit by a unified board,

The mining sector has enjoyed buoyant conditions over the past year, and not surprisingly has flourished. In 2005 the miner delivered a 118 percent increase in underlying earnings to just under US$5 billion. Cash flow was 85 percent higher at US$8 billion. Robust performances in Rio's principle markets, copper and iron ore, have been significant drivers.
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Based on today's upbeat first quarter operations report, we are confident of further earnings out-performance in 2006. As expected, performances were robust across the board. Most mines and plants operated at or near capacity in order to benefit fully from strong markets.

The group's share of iron ore production has increased by 4 percent on last year. Output from Hamersley in Australia (one of the world's largest iron ore producers) rose 9 percent to 20.4 million tonnes. The performance was resilient given the heavy rains following a succession of cyclones in Western Australia.

Rio's copper business benefited from a strong operational performance at the Kennecott Utah Copper smelter. Refined copper and gold levels increased 24 and 31 percent to 70,900 tonnes and 118,000 ounces respectively. The expansion of the moly plant last year also bolstered recovery rates for the by-product molybdenum.

The group's share of production at the 30 percent owned Escondida deposit in Chile increased 18 percent to 100,400 tonnes. Output growth was underpinned by higher grades and the commissioning of the Norte pit last September. The low cost deposit is one of the largest copper mines in the world, with an expected life in excess of 30 years.

In the energy business thermal coal production at Kennecott Energy in the US was marginally higher at 29 million tonnes. An expansion is underway at the Antelope mine, which drove quarterly production there to record levels.

Hard coking coal production in Australia declined 41 percent to 1.1 million tonnes in line with expected short term demand weakness. We however expect order levels to recover once settlement prices for 2006 are finalised.

In the aluminium group bauxite production was 12 per cent higher at 3.8 million tonnes due to the successful commissioning of the Andoom mine and processing plant. Quarterly output

from the Comalco Alumina Refinery of 257,000 tonnes was the highest on record, with th
plant ramping up to nameplate capacity of 1.4 million tonnes per annum.

Production at Argyle Diamonds in Australia meanwhile declined 40 percent to 5.2 million carats as the mine approaches the end of open-pit life. Elsewhere output at Diavik in Canada was steady at 1 million carats.

With production generally trending steadily upwards across the group, we are encouraged that exploration investment also remains high on the agenda. Exploration expenditure in the first quarter was US$57 million compared to US$30 million in 2005.

Rio plans to spend in excess of US$3 billion this year and next on brown-field and green-field projects. We believe such a level of investment will lay the foundations for significant earnings growth going forward. Rio has committed nearly US$3 billion alone to iron ore operations in Western Australia, expanding mine, rail and ports to meet strong demand principally from China. The company also plans to proceed with the 22 million tonne Hope Downs project.

Elsewhere management plans to extend the life of two of the group's largest and most mature mines. A US$760 million underground block caving project at Argyle will add at least another 11 years. In Namibia, US$82 million will be spent at Rossing Uranium to add 10 more years of production at the mine.

In addition Rio is developing the Cortez Hills underground gold project in Nevada with joint venture partner Barrick Gold (also in the Fat Prophets Portfolio). Construction of a US$775 million mineral sands project in Madagascar has also been approved.

Other advanced prospects in the pipeline include the La Granja copper project in Peru, and the Simandou iron ore project in Guinea. An agreement with Norilsk Nickel of Russia also offers exciting potential. The focus of the joint venture will be a large prospective region of far eastern Russia.

In addition to a robust production profile and project pipeline, we are also attracted by the company's capital return programme. Management plans to hand back $2.5 billion to

shareholders between now and 2007 through share buybacks. This should bolster investo
sentiment further.

Last week the shares achieved a new all-time high of 3240p. We believe price action in recent weeks confirms the continuation of the longer term upward trend. While a brief period of consolidation can not be ruled out, downside risks appear limited. Initial support lies between 3034p and 3018p with additional support at 2800p.

We believe Rio offers compelling value at current levels despite the rally over the past year. The shares trade on an average forecast price earnings multiple of around 12 times. In addition to an attractive valuation, the company has a robust pipeline of projects that should underpin growth in future years. We believe that the shares will undergo a further re-rating as analysts ratchet up their forecasts of commodity prices.

With worldwide demand for resources remaining firm we believe that companies such as Rio will continue to prosper. **Accordingly we reiterate the buy advice in last week's mid week alert. For Members who do not hold the shares we recommend buying up to 3150p.**

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