Recommendation: SELL  
Target Price until (12/31/2015): $39

1. Reasons for the Recommendation

Rio Tinto has received a “Sell” recommendation which is largely attributed to the forecasted decrease in demand for Rio Tinto’s goods. In addition, Rio Tinto has significantly underperformed the industry and forward guidance indicates this underperformance will continue.

Iron ore prices have dropped 9.5% since September in 2013 from $134.19 per ton to $121.37 per ton in February 2014. Analysts at Goldman Sachs are forecasting the price of iron will further decline to $113 per ton for 2014 YE, $90 per ton for 2015 YE, and $80 per ton in 2016. Iron ore constitutes over 31% of Rio Tinto’s revenue and this steady decline is the primary reason for downward revenues guidance.

This decline is largely attributed to China’s decrease in demand for materials. China is expecting to release controls on interest rate which will raise operating costs for businesses and slow the economic growth in China. In addition, China has announced that government subsidies, which were established in the 1980’s, will be dismantled by President Xi Jinping. This subsidy cut will increase operating costs for local businesses and could potentially slow China’s economic growth to as low as 3%\(^1\). The most important item to take note of is that China is experiencing a massive real estate bubble.

China has been purchasing vast amounts of raw materials to support the construction of “ghost cities” and give the country the illusion of strong economic growth. China has been building about ten ghost cities per year since 2004, some of which are larger than the size of New York City. These cities, such as Zhengzhou, are built to sustain over twelve million people but only have a population of twenty thousand. People have not moved into these new cities because apartments there are still priced around twenty thousand U.S. dollars and the income per capita of China is just over five thousand. It is estimated that there are 68 million single family apartments available in China at this moment. To put this in perspective, China’s available apartments could house 87% of America. China’s construction of these “ghost cities” cannot be sustained and their purchase of materials will inevitably decrease which will substantially effect Rio Tinto as China consists of 35% of their overall revenues.

Company predictions state that revenues for 2014 will decrease by 2% due to China’s decrease in demand for materials. This 2% annual decrease is anticipated to extend until 2016. However, this revenue decrease is expected to be offset slightly by further cuts in CapEx which should equate to an additional $700 million in savings for 2014.

Rio Tinto’s holding period return from December 12\(^{th}\), 2012 to March 17\(^{th}\), 2014 was only 6.28%. This is well below the industry average return of 36.2%. Dividends for the time period equated to $2.871 per share with disbursements occurring on a semiannual basis. The stock price only increased 42₵ in two years and had a risk adjusted return of -32.2%, indicating the firm’s underperformance to the S&P.

On a more positive note, management quality has improved since Sam Walsh took the CEO position on January 1\(^{st}\), 2013. Following his appointment, underlying earnings were up 10% in 2013 from 2012, operating costs were reduced by $2.3 billion since 2012 with an additional $0.7 billion planned for 2014.

\(^1\) (China's Subsidies End Prompts Forecasts for Slower Growth, 2014)
and cash flows increased to $20.1 billion. Walsh has been attempting to rebuild the company’s value by reducing CapEx and divesting from operations that are a “poor fit” with the firm.

The United States demand for aluminium is expected to grow as automakers are striving for better fuel efficiency with their vehicles. In 2012, the total US market for aluminium sheets was about 200 million pounds and is expected to reach 2 billion pounds by 2020. This tenfold surge in demand is a result of recent US government mandates which force automakers to increase corporate average fuel economy to 54.5 miles per gallon by 2025. As a result, aluminium prices are expected to rise, however the EIU Economic and Commodity Forecast predict the price will only increase 4.1%.

Aluminium constitutes about 20% of Rio Tinto’s revenues, but the segment’s underlying earnings were only $557 million in 2013 whereas iron ore’s underlying earnings were $9.9 billion. Therefore, China’s economic and political changes will have a greater impact on Rio Tinto than the demand increase for aluminium in the United States.

Although Sam Walsh has made significant improvements to the firm and the demand for aluminium is increasing, the negative impact from China’s material consumption decline, decrease in iron ore prices and poor holding period return outweigh all potential in the current equity position. After detailed financial analysis on the outlook of Rio Tinto, the price for 2015 YE is estimated to be $39. Therefore, Rio Tinto is receiving a “sell” recommendation.

2. **Company Analysis**

Founded in 1873, Rio Tinto is a worldwide mineral resource mining and production company. Being that the company is headquartered in London, RIO trades as an ADR (American Depository Receipt) on the New York Stock Exchange.

Rio Tinto’s operations are focused within five product groups. The first of these is the iron ore product group which is the largest contributor to Rio Tinto’s revenues with $26 billion in 2013 (Rio Tinto, 2013). The key customer countries of iron ore are China, Japan, and South Korea. Sales of iron ore are heavily concentrated in China and make up 31% of the product group revenue (about $8.06 billion) and 6.3% of total revenue. Thus, Rio Tinto’s performance is greatly affected by economic and political changes in China.

The aluminium product group contributed $12.4 billion in revenues in 2013, making it Rio Tinto’s second largest product group within its operations. The aluminium product group consists of bauxite, alumina, and aluminium with key operations located in Canada, Europe, and Australia. Asia, Europe, and the Americas are the key customer countries.

Rio Tinto’s 6-k indicates the firm either owns 100% interest or is a majority stakeholder in approximately 130 operations worldwide. From those 130 operations, Rio Tinto has become the largest aluminium supplier in the world.

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2 (The Economist Intelligence Unit, 2014)
The copper product group consists of copper, gold, silver, and molybdenum with $5.9 billion in revenues for 2013. Major operations are located in the US, Chile, Mongolia, and Indonesia with the US, China, and Japan being the main sales destinations.

Coal and uranium make up the energy product group and contributed $5.45 billion in revenues for 2013. Energy operations are located in Australia and Namibia with resource sales concentrated in Japan, South Korea, and Europe.

Rio Tinto’s smallest product group is diamonds and minerals as it only contributed $4.19 billion in revenues for 2013. Subgroups consist of diamonds, titanium dioxide, borates, and salt with operations in North America, Australia, and South Africa. North America, South East Asia, and India are the top customer countries.

Combined, performance on all segments led the firm to an overall EBITDA growth of 188% from a loss of -$3 billion to a gain of $3.6 billion.

Rio Tinto’s CEO is Sam Walsh who was appointed Chief Executive Officer in January of 2013 and was a Director since 2009. Walsh has been with Rio since 1991 and has held a number of positions within the firm, working his way up the ladder. Walsh holds 46,950 shares of Rio Tinto Limited and has kept the quantity of his shares unchanged for several years.

3. Industry Analysis

Although Rio Tinto is a significant global player, this industry is highly competitive with many global competitors who size are significantly larger than Rio’s. There are upwards of 190 publically traded companies within the Mining & Mineral industry. Of those 190, the top three direct competitors of Rio Tinto are Anglo American [AAUKF], BHP Billiton Limited [BHP], and Vale S.A. [VALE]. Rio is performing poorly in comparison to these three competitors. Out of the four companies, Rio Tinto is last in quarterly revenue growth, gross margin, net income, and earnings per share. In Rio’s defense, its direct competitors as well as the majority of the industry, are struggling and losing money on operations.

Adani Enterprises Limited [ADANIENT] is traded on the National Stock Exchange of India and Bombay Stock Exchange. Adani Enterprises is the dominating company in the industry in terms of revenue, generating $503.9 billion in the trailing twelve months. Hind Zinc, also traded in the NSE and BSE, is the 2nd largest in the industry but only generates $138.9 billion total revenue. Rio Tinto is within the top twenty firms with revenue of $50.1 Billion.

The industry’s operating profit margin and net profit margin is -0.02% and -8.64%, respectively. The materials industry saw -146.99% EPS growth, however Rio significantly underperformed that by -127% with an EPS growth of -273.95%.

Acquisitions and mergers are very common in the industry, with Rio Tinto being a major player. A key component of Rio Tinto’s business model is invest in or acquire other established businesses and mineral mines. The big players in this industry are constantly buying and selling their stake in various operations. This business models enables firms to offer a broad scope of products to customers as well as allocate capital investment throughout various operations in order to increase the net value of the firm.
Adani, Vale, BHP, and almost all other publicly traded firms practice this form of industry consolidation and are constantly selling and purchasing stake in various operations. They have turned this industry into its own “mine-exchange” where the goal of the firm is to allocate capital amongst these operations in order to diversify their asset portfolio and balance their investments. Ultimately, to increase the value of the firm and maximize return for shareholders.

China plays a substantial role in the price of iron ore as it is the world’s leading consumer. Therefore, changes in the economic or political landscape of China will directly result in fluctuations of the price.
Appendix

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Table 1 - Multiples Valuation Data

Table 2 - Holding Period Return
Works Cited


