

Opinion

FROM THE CAPITAL

Are BHP, Vale, Rio really clueless?

A failure to read markets, not flawed production strategy, is the major let-down

John Robertson*

According to CNBC television personality Jim Cramer: “BHP Billiton, Rio Tinto and Vale are morons.” Cramer provocatively likened the mining giants to the three stooges in an aggressive attack on their business acumen last week.

Cramer’s gripe was over how the three companies had responded to falling iron ore and copper prices. Rather than cutting back production, they have raised output, unnecessarily damaged their profitability and created losses for their shareholders, on his reckoning.

Although the most colourful and flamboyant of their critics, Cramer is not alone in wondering at the behaviour of the big three. His contrived over the top rhetoric raises some important questions about the capacity of the biggest companies in the industry to add value for their shareholders, but also conceals some important flaws.

As an investment generalist, Cramer has failed to understand the deeply embedded mining culture that gets the companies to this point. Faced with weakening prices, industry decision makers will usually try to maximise production. ‘Tons up the shaft’ is the long favoured catch-cry of experienced miners and their first reaction to an order to lower costs.

In mounting his onslaught, Cramer also failed to acknowledge the complicated balancing act faced by companies trying to protect market positions amid uncertainty about the reactions of their competitors.

Appallingly poor market conditions confronting the industry come from a fall in prices rather than sales losses. Between the cyclical peak in markets in 2010 and 2014, global steel production rose 17%. Copper use went up 18%.

There have been signs of weakness during 2015. Chinese steel production – accounting for about half the world’s total – is down 1%. Copper use appears to have dropped 2%. As cyclical changes go, these are relatively minor. The broad market for raw materials can still be characterised as growing despite the prevailing pessimism about profitability and the disappointingly slow speed of global economic activity.

A feature of the current cycle affecting profit outcomes has been unusually large movements in the US dollar. The beginning of the most recent down-leg in prices can be dated to the beginning of the US dollar foreign exchange uplift in July 2014. A production cut-



Three stooges: the intelligence of major miners has been repeatedly questioned

back is not going to do anything to avert the damage to prices from the exchange rate.

These conditions create a dilemma for the industry’s largest companies. With sales staff able to place as much as the company can produce, there is little grass roots incentive for production cuts. Any decision to reduce output will be driven a strategic view that a company will be better off supplying less than it could.

A cut in production, unwarranted by demand changes, will hand market share – perhaps permanently – to competitors. Those in the executive suites will need some reassurance that any such loss will be sustainably compensated for by a rise in price. They will also want reassurance that investment markets will be indifferent between an artificially created price outcome from output contraction and volume growth as drivers of profitability and market valuations.

A possible loss of face from cutting back may also impede a decision to act. The three iron ore majors have comprehensively misread the market in which they operate. When questioned about the durability of Chinese demand growth they had been saying, until only very recently, that iron ore growth would be sustained, possibly for decades more. These were always analytically suspect forecasts. Worse, they sparked market expectations and ultimately volatility that damages confidence in the whole sector.

Prices might have been vulnerable to collapse in any event. The exchange rate will have been one influence. Unwinding panic and speculation was another. Near the peak in prices, requests for assistance in sourcing iron ore for Chinese steel mills were commonplace. There was a sense of desperation in these solicitations. Fears of shortages also stoked expectations of quick riches among intermediaries delving into every corner for more supplies.

These were hallmarks of an unsustainable

market. They suggest the giant three were not to blame for the subsequent fall in price, but they had shown no moderation in taking advantage of conditions once they began to swing in favour of the sellers.

The big challenge now posed for the largest companies in the sector is to define how they will produce competitive returns on the capital they have acquired historically by arguing that “big is good”.

Superior investment returns were supposed to come from being the most diversified and being able to achieve economies unavailable to others. In reality, that strategic description missed an important ingredient. Success required consistently sound judgements about market changes and, importantly, flexibility to react correctly to anticipated changes in conditions.

Without the whole package, the largest companies remained at risk of the same fate as the smallest companies in the industry which, for different reasons, are also unable to react to changes in their circumstances.

None of the largest companies have been able to fulfill the promises they made to investors over a number of years. Their strategic and market analyses have proven unreliable. Little has gone right as they have lurched from one avoidable predicament to another.

Underpinning the comedy of Moe, Larry, Curly and Shemp was an unflinching ability to fall short of their overly ambitious aspirations. To that extent, Cramer’s comparison with the three stooges may have been apt.

There is, of course, one big difference. Whatever catastrophe befell the three stooges did not matter. Their jobs were to entertain by lurching into chaos in the most ludicrous manner. The three mining giants, on the other hand, are impoverishing their shareholders by their propensity to misread markets. They are not making anyone laugh. ▼

*John Robertson is a director of EIM Capital Managers, an Australia-based funds-management group. He has worked as a policy economist, business strategist and investment-market professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia