Mining Journal

BHP: investors demand change

BHP Billiton, despite a unique history and investment market standing, is a scaled up version of a failing investment model.

John Robertson* | 20 Apr 2017 | 4:47 | Opinion

Elliott Management chief Paul Singer is not the first and is not alone in challenging the BHP business model

Investment manager Paul Singer wants change at BHP Billiton. His open letter earlier this month proposes a revamped corporate structure to free the company's latent value.

Singer is the latest in a long line to have questioned the efficacy of the company's approach to generating investment returns.

Since Robert Holmes à Court launched his assault on the company over 30 years ago, BHP has been in an almost constant search for a sustainable strategy to match its size.

The Holmes à Court appraisal three decades ago is very much in the vein of Singer's proposals today for a re-balancing of how operational cash flows are used for the betterment of investment returns.

The Holmes à Court legacy took a long time to shake.

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As late as 1997, BHP was still the largest shareholder in Foster's Brewing Group. The stake in Australia's largest beer maker symbolised the corporate shenanigans ensnaring BHP in the 1980s.

Since then, a succession of company chief executives have each tried to refurbish the business model as investors have applied pressure for better outcomes.

"Trends in fund flows show the industry is attracting a shrinking share of investible funds despite hundreds more companies being listed"

North American copper, multi-commodity synergies, balance sheet strength, commodity diversity, commodity focus, commodity hubs, tier-one assets, production efficiency, asset divestments and four pillars of growth have all featured as slogans for a company zig-zagging ineffectively from one strategy to the next.

The company had once represented the Australian market. The simplest route to an Australian exposure for a foreign fund manager had been a holding in BHP.

Within Australia, the company has been the most widely-held stock for decades reflecting its hefty weighting in the relevant indices and an incomparable public profile.

As it remodelled itself into a global resources play, the company greatly changed its risk profile and relinquished its historical role as an ASX proxy.

Size has kept interest in the company alive.

BHP has had the balance sheet to make acquisitions periodically to sustain its profile as the biggest player in the sector but great bulk has often camouflaged business shortcomings.

Profit before interest and tax rose from US$9.9 billion to $32 billion between 2004/05 and 2010/11. Tellingly, this huge surge in earnings came entirely from higher commodity prices and even after some of their benefit was lost through the cycle from rising costs.

Neither organic growth nor business efficiencies were contributing to corporate value.

BHP shares did produce an annualised 46% return between 2003 and late 2007 but that was little different from the 48% annual return in the ASX small resources share price index.

In a like-for-like comparison from the bottom of the cycle in 1999 to the bottom of the cycle at the start of 2016, the BHP gain was a more modest 7.2%. Its dividend yield over the past 20 years, cited by many private holders as a reason to stay invested, has averaged 2.9%.

Over the same timespan between 1999 and 2016, the Australian bank sector, a direct competitor for investible funds, produced an annualised total return of 10.4% with lesser volatility.

Overall, being the biggest company in the sector has failed to produce premium returns for its supporters.

'From the Capital' columns over recent weeks have questioned the wisdom of the prevalent sector investment model.

In essence, the almost universally adopted model involves generating enough cash from a current project to fund another, hopefully bigger or longer lasting.

The risk inherent in the industry's approach has been heightened by frequently unfounded optimism driving decisions to withhold cash from shareholders.

Near the recent cyclical peak in iron ore prices, for example, those supposedly most knowledgeable about market conditions spoke of Chinese demand continuing to grow until 2030 despite mounting evidence the Chinese leadership was not going to let that happen.

Whether it is an industry tiddler or the unambiguous giant of the sector, the approach has been much the same.

Without more substantial cash disbursements from existing projects, investors incur a considerable risk. Retained cash can easily hit a lean spell leaving the sought-after value increment used to validate its retention out of range.

Unsurprisingly, the market prices in this risk leading to complaints that assets are being undervalued.

While the Singer analysis points to the oil assets, in particular, as being more effectively valued if separated from BHP's mining assets, the recommended divestment partially misses the point that the entire portfolio is prone to being undervalued, not just those parts involving oil and gas.

Patience with the industry's investment model has been wearing thin. Trends in fund flows show the industry is attracting a shrinking share of investible funds despite hundreds more companies being listed.

The industry has continued to rely on investors first recruited in the 1980s despite the increasing preference among aging investors for cash over capital gains and their reduced willingness to expose their retirement savings to commodity cycles.

The threat of capital gains taxes, which once dissuaded private investors from selling, is becoming a progressively less potent constraint as the pressure for cash builds.

Some commentators have concluded BHP will be saved from the clutches of Singer and like-minded international investors by its Australian followers. True, the reservoir of support runs deep, but there is no turning back the demographic tide.

BHP faces an existential threat from a loss of supportive investors. The biggest investors are getting cranky and it can no longer count indefinitely on an aging base of private investors in Australia.

That may not have been fatal except that, like the industry more generally, BHP has failed to court enough millennial investors to compensate for the inevitable erosion of baby boomer interest.

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