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# Stocks Down Under

***‘Prices are too high’ is far from synonymous with “The next move will be downward.” Things can be overpriced and stay that way for a long time ... or become far more so***

*- Howard Marks, The Most Important Thing*

## BHP – 7 reasons to be weary of the Big Australia

Stocks Down Under rating



**ASX:BHP    Share price: A\$ 39.90    Market cap: A\$ 118BN**

It’s certainly been a good year for BHP shareholders. The Big Australian started the year at \$32.47 and it’s now hovering around the \$40 mark. That, mind you, is below the 2019 high of \$42.08 registered on 3 July but, of course, ‘sell in May and go away’ is generally a good idea for the miners - over the Northern summer, metal and energy prices are seasonally weak because everyone over there seems to be on holidays. As usual, the mining stocks came to life again in October once the Northern Hemisphere returned to work, and that seems to have been

the main factor propelling BHP off its late August low of around \$35. So the Big Australian has momentum. Right now, however, we'd be cautious.

### Company Share Price Chart



Source: Tradingview

### Change of leadership

Our first cautious note is related to leadership. BHP just named a new CEO, with Mike Henry to take over the corner office from Andrew Mackenzie on 1 January. The latter presided over some good times for BHP, with the stock up 38% from the time of his announcement as incoming CEO to 14 November when we learned he would be stepping down. 38% is a hard act to follow. The risk with any new CEO is that he tries something new to distinguish himself from an illustrious predecessor, and that new thing doesn't work so well. With BHP the risk is probably lower because over the years the Big Australian has worked to be 'safe' and 'predictable' from a shareholder perspective. But you can never tell. Enough time has passed for memories of the bad times in the late 1990s, which were the result of poor capital discipline, to have faded. The 15% return rule for capital investment remains in place for now, but BHP threw off US\$10bn in free cash in FY19 and had gearing of only 15% at the end of the year so, as always, the temptation will be to move up the risk curve just a little bit. Remember, this company has committed publicly to list ROCE from 18% now to 22% ROCE by FY22. That isn't very far away.

### Coal prices in 2020

Our second cautious note concerns that traditionally big earner for BHP, coal, which was 17% of EBITDA in the second half of FY19 thanks to the company's mines in Queensland. You would have noticed that anti-coal sentiment has been growing around the world in recent years, and BHP has a fair bit of coal in its

portfolio. We wouldn't be surprised to see a lot of institutional mandates blackbanning BHP as a result of this exposure in the medium-term future. However, that's not the least of BHP's worries, which relate to the fact that coal prices, both metallurgical and steaming, have been weak in 2019 and in the Bowen Basin BHP's unit costs have been rising. BHP thinks it can get better coal pricing and unit costs in FY20. Unit costs maybe – this is a business where BHP is going autonomous in a hurry. Pricing-wise, we're not so sure. The world seems to be awash with surplus coal at the moment.

### **Short term caution with copper**

Our third concerns relates to copper and potash expansion plans. Medium term we are bullish on copper because of its future use in electric vehicles, but prices have generally on the slide since 2017. BHP gets a fair bit of its copper from Escondida in Chile – where returns weren't bad in FY19 – and from Olympic Dam in South Australia. For the latter mine returns have been very poor of late, and the brownfields expansion that BHP had been contemplating for a green light in 2020 may in fact become a red light. On top of that we're hearing that potentially the Jansen Potash Project in the Canadian province of Saskatchewan may not even start up because the global outlook for potash prices isn't as rosy as it once looked – basically too many other lower-cost potash deposits are on the runway besides them.

### **Chilean sovereign risk**

The mention of Chile in the previous paragraph prompted another thought: You've got to worry that Escondida might not necessarily be the gift that keeps on giving for BHP shareholders in 2020. If you've been watching the evening news lately you would have noticed that sovereign risk has kicked up in that hitherto-impressive Latin American country. One suspects that it's going to be a little more difficult to run copper mines in Chile once President Sebastian Pinera's time is up in early 2022 and the country wings to the Left again. Sovereign risk isn't generally something people think about with BHP, but have you noticed that one of the biggest expansion opportunities BHP has in Latin America is in Ecuador, where BHP just increased its stake in a copper miner active there called SolGold plc? Sure, SolGold's Cascabel copper-gold project is so big it could run for more than half a century, but Ecuador, under President Lenin Moreno (yes, he was named after Vladimir Lenin), is today one of the most economically unfree countries in Latin America according to the Heritage Foundation. Mmmm. Maybe BHP isn't as safe as many think it is.

## **More bad news out of Samarco?**

Staying in Latin America, our fourth concern for BHP is Samarco, BHP's long-standing iron ore joint venture with Brazil's Vale SA. In November 2015 a Samarco mine near the town of Mariana in the state of Minas Gerais saw its tailings dam fail, resulting in flooding that killed 19 people. It's fair to say the Mariana disaster has been a legal and public relations nightmare for BHP as well as Vale and might continue to be a bad news story in 2020 in and out of court, even if the mine eventually restarts, as intended.

## **Stubbornly high unit costs at Nickel West**

Our sixth concern is nickel. That devious metal was showing promise up until August or September, but it has since fallen in a heap. That's not great for Nickel West, the fully integrated mine-to-market nickel business that WMC lovingly assembled out of Kambalda and Kwinana a long time ago and where WMC's acquirer, BHP, has been contemplating expansions given the huge increases in reserves of recent years. Alas, unit costs at Nickel West are stubbornly refusing to go down.

## **Oil price may not recover to 2018 levels any time soon**

Finally, there's petroleum. Some of BHP's best expansion opportunities are in oil and gas right now, but it's not clear at the moment that West Texas Intermediate is going to be able to recover the levels above US\$70 we last saw in late 2018.

## **It's not all negative**

Now, there are some things that are going right for BHP at the moment, and we don't just mean the weak Australian dollar, which obviously benefits the biggest miner in the country even though it reports, and more or less thinks, in US dollars.

The top success story right now is iron ore, where BHP earns roughly half its EBITDA. It took BHP about four decades, but the company finally has the lowest cost iron ore mines in the Pilbara, which is good news given that iron ore prices appear to be rallying as China contemplates more infrastructure investments.

We also think in FY20 BHP will have some good things to say about productivity given its heavy investment in technology. BHP has been able to show over the last couple of years that its first fully autonomous haulage system at the relatively new Jumblebar iron ore mine in the Pilbara (the mine only opened in 2014) has worked like a dream in terms of improved safety and therefore lower costs. 2020 will see a large fleet of Komatsu trucks in the Queensland coal mines go autonomous as well. Productivity gains, however, probably won't be enough to generate strong earnings growth for BHP over the next two and a half years.

We suspect margins will be better in FY20 mainly because of iron ore, but those gains may then be given up in FY21 and FY22.

***All up, we think the negatives slightly outweigh the positives as we continue to progress through FY20. If investors are looking for exposure to the large miners this year, Rio Tinto (ASX:RIO) is probably the better bet. It's got more modest pricing – a P/E of only 10 versus 13 for BHP on FY20 consensus numbers. You still get to benefit from bullishness on iron ore, and investors can get some serious upside should there be any progress on moving the troubled but truly massive Oyu Tolgoi copper mine forward in Mongolia.***

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