Private Client Research

24 October 2019

Rio Tinto

New Zealand smelter review

Rio Tinto (RIO) announced its Tiwai Point aluminium smelter in New Zealand was under review, with closure in 2020 being a possible option.

Ord Minnett makes the following observations:

1. Rio Tinto has tried unsuccessfully to sell its Pacific Aluminium business and, given the difficult aluminium outlook, the other smelters could now face similar reviews.
2. The smelter's electricity provider Meridian Energy noted the closure cost of the asset has been estimated at NZ$256m (US$164m). Using this as a guide for the closure costs of the other three assets, the total remediation charge could be US$600–700m if Rio Tinto were to exit.
3. Pacific Aluminium has the highest emissions intensity of businesses in the Rio Tinto portfolio. The company's environmental, social and governance (ESG) strategy could incentivise management to close, rather than operate, some or all of the remaining smelters.
4. The Tiwai Point smelter accounts for 0.5% of global aluminium supply, and so its closure would help tighten markets, thereby increasing the profitability of Rio Tinto's core aluminium smelting business in Canada.

We maintain our Buy recommendation on Rio Tinto with a $99.00 target price.

- **New Zealand smelter –** Rio Tinto's Tiwai Point smelter in New Zealand is facing a strategic review, with closure being a possible option. The company stated "*we expect the short to medium outlook for the aluminium industry to be challenging and this asset to continue to be unprofitable*". The smelter is owned 79% by Rio Tinto and 21% by Sumitomo Chemical Company.
- **Closure and remediation costs –** Meridian Energy noted the closure cost of the asset has been estimated at NZ$256m (US$164m). This is likely to act as a deterrent should aluminum prices unexpectedly improve in the near term.
- **ESG implications –** In 1H19, Rio Tinto's Pacific Aluminium business (including the Bell Bay, Boyne, Tomago and Tiwai Point smelters) generated a net loss of $96m. In our view, the remainder of the business is likely to be under review given its low profitability. An additional factor that is likely to drive Rio Tinto to review this business is its high emissions intensity, with the emissions per tonne of copper equivalent production being the highest in Rio Tinto's portfolio.
- **Remediation costs –** Applying the same remediation cost for Tiwai Point to all four smelters would result in an estimated US$600–700m remediation charge. High closure costs usually mean companies try to squeeze costs and run assets for cash in the hope that prices will improve. For this reason, it isn't a foregone conclusion that Rio Tinto will look to close all of the smelters. There has been no disclosure from Rio Tinto on asset-level closure costs. Total Pacific Aluminium production is about 1.6Mtpa.
- **Aluminium market impact –** Tiwai Point produces around 340,000tpa versus global primary aluminium production of around 64.3Mtpa, meaning the asset accounts for 0.5% of global supply. On its own, we believe the closure would have only a marginal impact on prices. Having said that, Alcoa has also announced 1.5Mt of its capacity is under review.

Recommendation
Buy
Risk
Medium
Target price
$99.00
Last price
$89.80

Price Performance

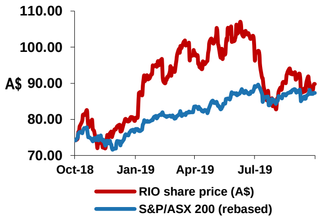
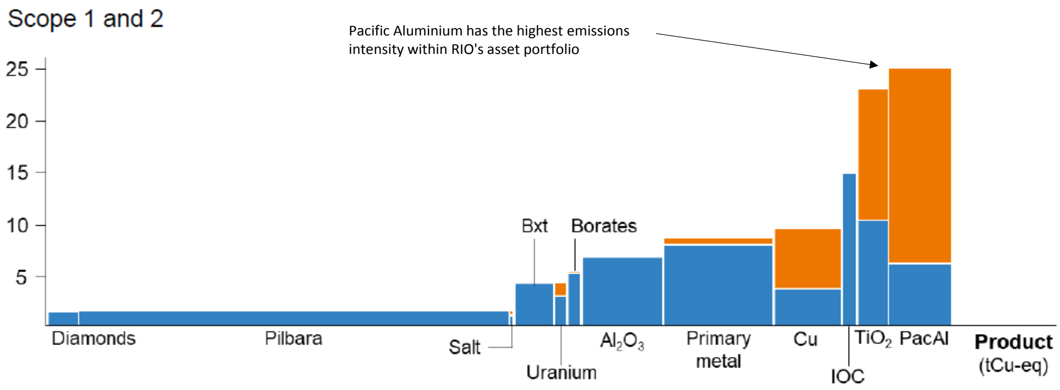
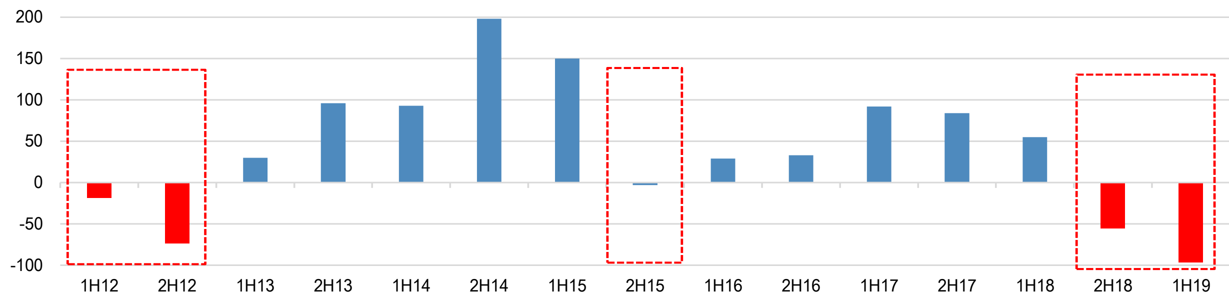


Figure 1: Rio Tinto emission intensity (tCO2e/t copper equivalent production)



Source: Company reports.

Figure 2: Pacific Aluminium net income/loss (US$m)



Source: Company reports.

Investment Thesis, Valuation and Risks

Investment Thesis

Rio Tinto is Buy rated based on strong P/NPV support, attractive FCF and dividend yield, along with a low EV/EBITDA multiple. The stock is our preference amongst the diversified miners.

Valuation

Our Dec-20 PT is based on our NPV estimate rounded up to the nearest dollar. Our NPV is based on a sum-of-the-parts DCF valuation using a 10% discount rate. The 10% discount rate is in line with our coverage universe.

Current DCF	US$m	A$m	A$ps
Iron Ore	81,662	109,106	67.25
Aluminium	17,208	22,991	14.17
Copper	20,844	27,848	17.17
Energy	-	-	-
Diamonds, Minerals, Other	6,976	9,321	5.75
Total operations	**126,690**	**169,266**	**104.34**
Net debt	(4,245)	(5,672)	(3.50)
Corporate costs	(2,152)	(2,875)	(1.77)
Exploration	-	-	-
Total valuation	**120,293**	**160,719**	**99.07**

Source: Ord Minnett estimates.

Risks to Rating and Price Target

Downside and upside risks include: 1) outcomes in commodities, currencies, production, costs and capex relative to our forecasts; and 2) changes to tax, legislation and other operating conditions.

Please contact your Ord Minnett Adviser for further information on our document.

Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.

SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historical volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.

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