BHP Billiton Limited BHP [NYSE] | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
99.80 USD	89.00 USD	62.30 USD	124.60 USD	Medium	Narrow	—	—	Industrial Metals & Minerals

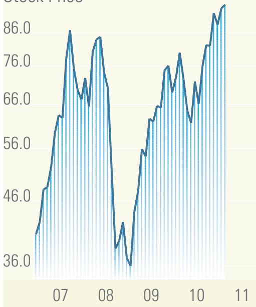
BHP's Record-High Fiscal First Half Still a Touch Soft

by Mark Taylor
Stock Analyst
Analysts covering this company do not own its stock.

Pricing data through April 15, 2011.
Rating updated as of April 15, 2011.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Stock Price



Analyst Note Feb. 23, 2011

BHP reported a 68% increase in adjusted first-half fiscal 2011 net profit to a record $9.6 billion, marginally below our forecast. It has been 18 months since the miner last reported a similar result. This time iron ore and coking coal shone, offsetting a wallowing aluminum division and weak manganese. Oil and copper were also important. The significance of volumes pales in comparison to price. Key to the result being slightly softer than expected were higher operating costs for coking coal and aluminum--Queensland floods exacerbating the former--and weak manganese prices. Aluminum in particular is sensitive to higher fuel and energy prices and suffered. Better-than-expected performance from iron ore on cost, and copper and oil on price, was a partial offset.

BHP reported a 72% jump in headline profit to $10.5 billion including $314 million in costs associated with the unsuccessful PotashCorp takeover bid, a $1.1 billion gain predominantly due to an increase in the value of future tax depreciation on exchange rate movements and a $138 million gain on release of tax provisions. The company excludes only the PotashCorp costs and $138 million tax provisions from its $10.7 billion underlying earnings figure while we add the $1.1 billion tax gain to our exclusions list--only the PotashCorp costs are real.

BHP declared a $0.46 interim dividend, a 10% increase and just above our $0.45 target. Noteworthy is the expanded $10 billion capital management initiative to be completed by the end of 2011. The company will consider both on- and off-market purchases with a total of around 4% of issued capital at the current share price. And it apparently won't get in the way of $80 billion earmarked for major project development, including iron ore and metallurgical coal, during the next five years.

We can see an argument for shareholders being underwhelmed by the paltry 27% dividend payout. But that's the risk of any acquisition, including the buyback, occurring at the top of the cycle. But BHP has had the progressive dividend policy in place for a long time, and the company has delivered impressive total returns.

Short term, BHP is cautiously optimistic on the economic outlook. For the longer term, it expects a slower but more sustainable Chinese economic growth model to lead to a reduction in resource intensity per unit of GDP. This outlook supports our general thesis for a gradual decline in commodity prices to a level still well above longer-term historical averages--plenty for a company to make respectable returns. Our fiscal 2011 earnings forecast declines 2% to $23.6 billion. Fiscal 2012 is unchanged at $29.5 billion. Right now Rio Tinto's more pronounced share price discount to valuation makes it the more attractive investment proposition.

Thesis Feb. 23, 2011

After 30 years of decline--since the late-1960s peak of the last long-cycle uptrend--the world is again experiencing sustained increase in commodity prices. The last long-cycle uptrend, born at the end of the Great Depression, was driven by the rebuilding of Europe after the wars and later on the rise of Japan to economic powerhouse status. The oil shocks of the 1970s were an effective death knell. The current rise, forged on the industrialization and urbanization of the world's most populous country, began early in the final decade of the 20th century, though the seeds were probably sown considerably earlier.

China's meteoric rise from economic obscurity has sustained commodity price growth for over a decade and into the 21st century. Despite now accounting for the lion's share of global consumption of many commodity staples, its per capita use remains well below that of industrialized nations--the difference being China's vast population. And India's near-equivalent numbers portend a lagged reinvigoration of commodity price support. The

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
BHP Billiton Limited	USD	278,915	62,354	26,922	17,111
Vale S.A.	USD	172,325	36,697	15,631	12,866
Rio Tinto PLC	USD	139,321	56,576	19,694	14,324
Freeport-McMoRan Copper & Gold	USD	48,432	18,982	9,068	4,273

Morningstar data as of April 15, 2011.

decade milestone of growth need not spell the end of the current boom.

Positioned in the eye of this enviable tailwind, BHP is the world's largest publicly traded mining conglomerate, with the financial wherewithal to weather the boom-and-bust cycles of the volatile commodity markets. Geographic and product diversification give BHP more stable cash flows and lower operating risk than most of its mining peers. Most revenue comes from the relative safe havens of Australia/New Zealand, North America, and Europe.

This narrow-moat company has several key advantages. It produces a range of commodities from oil and gas to diamonds, and it is a major producer of iron ore, copper, nickel, thermal coal, metallurgical coal, and manganese. It also offers a full suite of conventional energy products. The company can benefit from a rally in any of its product lines. Finally, BHP is a major Australian commodity producer in close proximity to the Asian markets.

A geographically diversified customer base allows BHP to benefit from economic growth and development in any part of the world. When all major world economies are growing strongly, BHP's revenue and profits can benefit significantly. With demand for most of its products in an upswing--because of the growing Asian economies and worldwide economic expansion--BHP reported stellar results in fiscal 2005-08. Fiscal 2009 softened with the global financial crisis, but the company's diversified earnings stream damped the overall volatility associated with the downturn. Fiscal 2010 delivered improved profits, and 2011 stands to be another record result.

The good times have fortified the balance sheet. Some cash has been returned to shareholders, but the bulk of the windfall is financing growth. Since the $8 billion acquisition of WMC in 2005, BHP has approved billions in expansion projects. The development pipeline is strong. With modest net debt of $3.3 billion at the end of fiscal year 2010, there is plenty of room for further development projects or acquisitions.

It is difficult to create and protect competitive advantages while focusing on multiple commodities. With the exception of iron ore, we think BHP lacks real pricing power in its products. There is a risk that expanding at near-peak market conditions will result in lower-than-optimal returns on investment. However, with its impressive portfolio of businesses in terms of size and scale, BHP has a narrow economic moat, in our opinion.

Valuation, Growth and Profitability

We've reduced our fair value estimate to $89 per share from $90 following a marginally weaker-than-expected profit result from the first half of fiscal 2011. This is a modest decline following a more meaningful increase in near-term iron ore price forecasts and longer-term aluminum prices. For iron ore, we raise first-half calendar year 2011 13% to $153 per metric ton, second-half calendar year 2011 6% to $143 per metric ton, first-half calendar year 2012 11% to $134 per metric ton, and second-half calendar year 2012 3% to $124 per metric ton. Our long-term aluminum price forecast increases 8% to $1.30 per pound. We don't believe $1.07 per pound spot reflects realistic longer-term fundamentals.

For near-term earnings in the context of a softer-than-expected first-half result from fiscal 2011, we reduce our fiscal 2011 earnings forecast 2% to $23.6

billion. Our fiscal 2012 forecast is unchanged at $29.5 billion. Higher iron ore prices and iron ore capacity upgrades drive the higher 2012 versus 2011. BHP guided more aggressive expansion milestones than we had factored in. Approved expenditure includes early works on Rapid Growth Project 6 (RGP6) to increase installed Western Australian capacity to 240 million metric tons per year by 2013; BHP's share is 85%. This is a rise of 60% over current annualized production levels.

Key long-term valuation assumptions are $70 per metric ton iron ore, $120 per metric ton coking coal, $2.50 per pound copper, $1.30 per pound aluminum, an AUD/USD exchange rate of 0.80, and a 10% discount rate.

Risk

We believe BHP merits a medium fair value uncertainty rating, as individual commodity price volatility is offset by mineral diversification and a relatively robust balance sheet. This does not imply a lack of risk, however. BHP faces all the environmental and operational risks associated with mining as well as the country-specific risks associated with some of its assets.

Bulls Say

- BHP is a beneficiary of continued global economic growth and increased demand for the commodities it produces.
- BHP's cash flow base is diversified, and the company is less susceptible to the vagaries of the market than single-commodity producers.
- The company has an attractive, low-cost, long-life portfolio of expandable operations.
- Growing producer concentration is slowly tipping pricing power away from the end user and toward miners.
- Steady cash flows allow BHP to invest throughout the cycle.

Bears Say

- Sovereign risk heightened following the Australian government's intended Resource Super Profits Tax. The softer replacement Mineral Resource Rent Tax has reduced, but not erased, this risk.
- The global economy is cooling off; demand for commodities will follow suit.
- Diversified miners' stocks always trade at discount valuations to pure plays. Investors interested in gaining exposure to a specific commodity would be better off investing in pure plays.
- BHP is subject to the long-term supply/demand balance for metals, a major factor in determining the company's profitability.
- Chinese minerals investment, for production rather than profit's sake, could erode some of the limited pricing power mining companies have recently won.

Financial Overview

Financial Health: The company is on strong financial footing. Returns on invested capital have averaged 25% during the last five years, and remained above 20% even during the global financial crisis. The worth of BHP's diversified earnings stream was tested and proven. The company has reinvested throughout the cycle. Five-year average EBITDA margin is a very healthy 45%.

Company Overview

Profile: BHP Billiton is a diversified miner that supplies aluminum, coal, copper, iron ore, mineral sands, oil, gas, nickel, diamonds, uranium, and silver. A 2001 dual-listed merger of BHP Limited (now BHP Billiton Ltd.) and Billiton PLC (now BHP Billiton PLC) created the present-day BHP Billiton. The two still operate as separate firms but are overseen by the same board and management team. Shareholders in each company have equivalent economic and voting rights in BHP as a whole.

Management: CEO Marius Kloppers took the reins from Chip Goodyear in October 2007. He was expected to be more aggressive on the acquisition-and-development front while adhering to the Tier 1 asset-only policy. Confirmation came with the unsuccessful 2008 Rio Tinto and 2010 PotashCorp bids. Some shareholder unease has arisen over these costly forays. The depth and strength of the board should ensure a deal isn't done for a deal's sake. Likely targets exist in the oil and gas space where antitrust issues are unlikely to feature.

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Analyst Notes

Feb. 23, 2011

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Feb. 08, 2011

BHP Reports Fourth-Quarter Results

Almost three fourths of our BHP valuation derives from just three commodities: iron ore, copper, and petroleum. We stick to these in our commentary on second-quarter fiscal 2011 output.

Analyst Notes (continued)

Iron ore production rose 5% to 33.7 million tonnes, a good result and better than expected. The company has expanded output by around 25% from levels three years ago and has sizable ongoing expansion programs. It approved expenditure including early works on Rapid Growth Project 6 (RGP6) to increase installed Western Australian capacity to 240 million tonnes per annum by 2013 (BHP's share 85%). This is a rise of 60% on current annualized production levels. Beyond RGP6, long-term growth to 350 million tonnes per annum is also considered. BHP has aggressively pushed expansions since the collapse of the proposed Pilbara joint venture with Rio Tinto. BHP's plans are comparatively more aggressive, though coming off a lower base and representing a smaller share of group earnings. All things considered, expansion plans are probably similarly meaningful for each, despite Rio Tinto's comparatively less onerous target.

BHP grew fourth-quarter copper production 4% to 302,000 tonnes, ahead of expectations. It had warned of weaker near-term output at Escondida due to scheduling issues and declining head grades. Solid performances were enjoyed from Olympic Dam and Antamina. Escondida is still likely to see a 5%-10% decline over 2010 due to grade. Olympic Dam expansion plans are ongoing, but it will be a slow process to move that monster forward. Lethargy in copper production is in stark contrast to iron ore's expansion. Declining head grades and prohibitively expensive up-front development temper production growth. It has also made sense to limit new production, as the plus $4 per pound copper price can attest. BHP has held its ground with Spence in Chile, offsetting copper decline elsewhere. For the moment, it seems to be happy to let copper revenues grow in the face of stagnant volumes.

BHP grew petroleum production at an impressive cumulative average rate of 11% from 2007. Against the trend, second-quarter fiscal 2010 output fell 14% to 37 million barrels of oil equivalent, though only marginally below expectations. Deferral of drilling in the Gulf of Mexico, flooding in Pakistan, lower than average East Australian seasonal demand, and planned facilities downtime all had an impact. We anticipate a return to trend and gas projects Angostura and Macedon to come on in 2011 and 2013, respectively.

Our BHP valuation is marginally higher. Contributing are higher near-term iron ore and longer-term aluminum price assumptions. We don't believe $1.07 per pound spot reflects realistic longer-term aluminum fundamentals. Near-term earnings forecast an increase on iron ore prices, but also after accelerating iron ore capacity upgrades. BHP guided more aggressive expansion milestones than we had previously factored in.

Dec. 21, 2010

BHP and RIO the Last of the Big Spenders

How do the spending plans of Australia's diversified mining majors stack up? BHP's balance sheet is ungeared and Rio Tinto's is inching closer. When looking solely on the basis of gearing BHP appeared positively miserly over the last decade--with average gearing around 33%. It would have been a starkly different picture if bids for RIO in 2008 and/or PotashCorp in 2010 had proven successful. Perhaps a picture more akin to RIO's none-too-brief flirtation with 200% gearing levels following the $38 billion Alcan acquisition in 2007. A $15 billion restoring rights issue in 2009 and non-core sell-downs have RIO on the front foot again. Not to mention extraordinarily favorable iron ore prices and top-heavy Pilbara iron ore exposure! At 66%,

Analyst Notes (continued)

RIO's average gearing over the last decade is around double BHP's.

On average BHP and RIO expended the equivalent of 14%-15% of revenue on new capital investment, excluding acquisitions. The difference is BHP spent comparatively less at the beginning of the decade and more toward the end. RIO's expenditure levels halved following the Alcan acquisition and only after two years are they now back to 15% of revenue. The $15 billion entitlement issue, belt tightening, belated non-core asset sales, and strong commodity prices brought RIO back from over-indebtedness far sooner than might otherwise have been expected.

BHP delivered the superior returns on invested capital (ROIC)--25% on average over the last decade versus RIO's 18%. Only in 2006 did RIO's returns match BHP's, courtesy of high iron ore and copper prices. Alcan and poor aluminum prices erased that advantage for RIO in subsequent years.

Is RIO a diversified miner? It's getting harder to claim that with 60% of EBIT now derived from iron ore alone. Copper remains a reasonable slice at around one quarter, but coal, aluminum and industrial minerals are becoming tantamount to also-ran commodities. As for diamonds, forget about it! BHP maintains a far more balanced portfolio although even here there is a decline in symmetry toward steelmaking materials or CSMs--metallurgical coal, manganese, and iron ore. Of course this is not necessarily a bad thing--you've got to make profits where there are profits to be made. But still we can't help but harbor some concern around increased exposure to one segment. It's working in the miners' favor at present and they are running with it.

How much of the increasing earnings asymmetry is a function of commodity prices as opposed to directed investment? Noteworthy for RIO is the decline in aluminum's contribution despite the massive Alcan acquisition. Aluminum for BHP is also presently a sliver of its former self.

For BHP and RIO the growth in importance of CSMs to earnings is a function of investment skew and prices. Each has grown the proportion of investment dollars directed to CSMs considerably. Over the decade, BHP doubled CSM expenditure to 40% from 20% of the total. RIO didn't grow it as sharply but it was generally already higher, on average 35% of total capital expenditure versus 30% for BHP. However, the growth in earnings contribution from CSM was even sharper, tripling for RIO and nearly doubling for BHP. High iron ore and coking coal prices were a key driver of this growth in earnings. Aluminum expenditure as a proportion of total spend was surprisingly high for RIO and this ignores the Alcan purchase cost. You wouldn't know it though from the earnings profile--RIO is well-primed for an aluminum turnaround. Also interesting is the cranking-up of oil and gas expenditure by BHP.

BHP spent $11 billion in fiscal 2010 and is planning $15 billion in fiscal 2011. It has 20 projects in the growth pipeline with some of the bigger-ticket items on oil and gas. These include Macedon $1.1 billion, Bass Strait $1.1 billion, and NWSJV over $1.0 billion. The company recently approved $570 million for Rapid Growth Project RGP5 expanding on earlier pre-commitments of $1.7 billion. RGP5 increases Pilbara iron ore capacity by 50 million tonnes to 205 million tonnes by 2011. Further, it wouldn't surprise us if BHP is furiously running the ruler over Woodside Petroleum, now that Shell has flagged its exit intentions. BHP missed out on RIO and PotashCorp and its balance sheet is chronically under-geared--even with capex plans and the re-instituted $4.2 billion buyback of Billiton shares.

BHP remains our preferred diversified major. It had the more consistent and superior returns over the last decade, reliably invested throughout the commodity cycle and retains the more diversified and balanced asset portfolio.

Analyst Notes (continued)

Capital expenditure plans suggest it will stick to this approach. Our valuation climbs marginally to $87 per share after a rise in near-term iron ore price forecasts. Fiscal 2011 iron ore increases 13% to $130 per tonne and fiscal 2012 10% to $113 per tonne.

Nov. 19, 2010

With Great Power Comes Great Responsibility: Notes from BHP's Annual Meeting

Social responsibility is always something companies are keen to advertise at annual general meetings, and BHP Billiton predictably wheeled out its triumphs: injuries down, taxes and royalties up, and a promise to seek even better standards moving forward. But the subject seemed to dominate an even larger share of the limelight than usual. Perhaps it was the sting of the Australian government's watered-down resource super profits tax--the mineral resources rent tax--the implication being that BHP isn't paying its fair share. Or was it a reaction to the regulatory knock-backs for the Pilbara iron ore joint venture and PotashCorp bid--a licking of the wounds? Is BHP too big to be a good thing for the world? Or maybe CEO Marius Kloppers simply invited a green-washing in his call for a clear carbon price signal.

Whatever it was, it made for an odd 150th anniversary meeting for a mining company. Does BHP really think anthropogenic carbon dioxide emissions contribute to a global temperature rise? Chairman Jacques Nasser made a seemingly strong statement: "For several years now, we have recognized that the science of climate change demonstrates that human activities have a negative impact on our climate and consequently pose risks to our society and economic well-being." However, it's still unclear. By accident or design, Nasser's statement makes no direct reference to carbon dioxide and is one step removed from BHP's position. Further, it's ambiguous, potentially recognition only of someone else's stance.

Does it really matter anyway? We've previously argued a tax on carbon is really just an exercise in wealth redistribution. The trick is to make sure you're on the right side of the equation. BHP's diversified business model will have some divisional winners and some losers. We highlighted Olympic Dam's uranium as a winner. And customers may end up wearing much of the carbon cost in any case, as long as there's a globally level playing field. Kloppers reported, "This year our total energy use and greenhouse gas emissions were the lowest since 2007. We have reduced the amount of greenhouse gas emitted per unit of production by 7% in the last four years." We're unsure whether this was a function of product mix or genuine gains.

There was positive commentary on more familiar ground. Nasser said, "We are witnessing an extraordinary structural shift and period of growth in the global economy toward China and other emerging markets, and we are still only at the beginning of this era of growth and change." Further, "As a board, we feel confident that these factors will drive continued global economic growth and, importantly, long-term demand for our diversified portfolio of products." And, "We believe that our products, combined with our capacity to scale up to meet this unprecedented demand, positions BHP Billiton in a pivotal time and place in history." No ambiguity there! BHP is in a sweet spot that has a long way to run yet. The company highlighted the still-low per capita income and the number of economies at initial stages of their development, India the most obvious.

A much-anticipated grilling for failed takeover bids turned out to be a nonevent. Nasser later expressed the board's full confidence in Kloppers to pursue further acquisitions. Woodside Petroleum, here we come? BHP highlighted the benefit of its diversified earnings stream through unprecedented global financial disruption. The more stable sum of parts allows investment throughout the cycle. Kloppers said, "The pullback in investments by our competitors during the global financial crisis means that supply is lagging. As a result, the overall supply-demand conditions are favorable to us." What about the suggestion that BHP is too big to grow? Kloppers' answer: "We are a scalable organization with a simple portfolio of large upstream expandable assets." It's business as usual with a socially responsible bent.

Nov. 15, 2010

What's Next in BHP Billiton's Crosshairs?

BHP Billiton has withdrawn its $40 billion bid for Canada's Potash Corporation of Saskatchewan. Minister of Industry Tony Clement did not see a net benefit to Canada, despite seemingly very generous concessions and undertakings on BHP's part. Clement's words effectively killed BHP's chances. It's another one that got away, in addition to the Pilbara iron ore joint venture proposal and the Rio Tinto takeover bid.

Markets don't like uncertainty, and a bid for a nonstaple commodity like potash is even worse. BHP shares had underperformed Rio Tinto since the bid was announced. This was a bit of a punt on a global future of declining arable land and water shortage, which is highly likely but not a given--and definitely not here and now like a staple copper producer. The press is painting this as another failure in agenda for BHP CEO Marius Kloppers. To the contrary, we see a company taking sensible potshots with the discipline not to overpay or compromise for the sake of sealing a deal. That said, the costs are mounting, this time to $350 million, of which $250 million relates to the $45 billion acquisition financing facility.

Now market attention is refocused on the most obvious of acquisitions, Australia's Woodside Petroleum, particularly since Shell flagged its intention to exit, already selling down a 10% stake for $3.3 billion. Woodside is now in play, and BHP is the favored bidder. Any move by another party is likely to spark a not-in-my-backyard response from BHP. As an Australian company, BHP has a regulatory head-start. The impediments to a foreign takeover of Woodside are not as tall as they were for Shell back in 2001, however. There are now many prospective Australian-based LNG players, both on the east and west coasts.

BHP would probably need to pay at least AUD 55 per Woodside share, a 28% premium to the market price, and potentially considerably more. It would still be a bargain. The company is better off paying cash, given its very strong balance sheet. Scrip bids are inherently more dilutionary to earnings and valuation but easier on the balance sheet. Assuming cash, leverage might peak at around 85% net debt/equity (46% net debt/net debt plus equity) before rapid paydown. Sell-down of noncore assets could accelerate the process. Synergies might allow BHP to bid a bit more.

BHP has reactivated the remaining $4.2 billion component of its previously suspended $13 billion share buyback. This could be a very efficient use of capital, particularly focused on the London-listed stock, which trades at a chronic discount to the Australian Securities Exchange. It need not come at the expense of a Woodside bid. In fact, the uplift to earnings metrics from the buyback makes a scrip

Analyst Notes (continued)

component to any Woodside takeover bid more palatable.

Oct. 27, 2010

BHP Billiton Reports 1Q Results

BHP Billiton's fiscal first-quarter production performance had a similar feel to Rio Tinto's. Most assets are operating at or close to capacity, and compared with the fourth quarter of fiscal 2010, petroleum, alumina, copper, iron ore, and energy coal all enjoyed stronger sales volume. Exceptions were aluminum, down sharply because of the timing of shipments (production actually rose marginally), and nickel and coking coal. We were a touch disappointed by key divisions copper, iron ore, and coking coal--all below expectations. These are the three major value drivers for BHP, and their performance is crucial. We remain positive on BHP. It remains the preferred of the diversified majors--subject to stock price, of course.

We noted Rio Tinto's lackluster output from copper operations, and BHP is no different. BHP's equity copper output fell 30% since the second half of fiscal 2008, from 727,000 tonnes to 507,000 tonnes in the second half of fiscal 2010. Olympic Dam had issues with its Clark shaft in 2010, but even so, decline in head grade at the likes of Escondida is a key factor. It's not all bad, though, with the pattern not confined to BHP and Rio Tinto. London Metal Exchange copper stockpiles fell 30% from 550,000 tonnes to 375,000 tonnes over the past six months and copper prices jumped 35% to $3.75 per pound, with U.S. dollar weakness helping. BHP's base metal revenue has risen since the first quarter of fiscal 2010 despite softening copper output. The metal could again soon be testing $4 per pound.

Iron ore is a different matter, with production rising relatively consistently for more than a decade. Tie-in activities for RGP-5 took the shine off the first quarter, though output was still above both the fourth quarter and the previous corresponding period. There were no real issues other than a lost opportunity with the failed Pilbara iron ore joint venture with Rio Tinto. Coking coal output was affected by maintenance at Queensland and Illawarra. Heavy Queensland rains restricted overburden removal, which could further crimp second-quarter production. Energy coal volume rose strongly, by 16% to almost 18,000 tonnes. Continued ramp-up at Klipspruit and improved performance from Khutala, both in South Africa, drove the increase.

Aside from commodity prices, and given that the iron ore joint venture is now dead, key uncertainties are the PotashCorp bid and the Mineral Resource Rent Tax. The press has the Saskatchewan authorities keen to reject the bid, something we suspect the market wouldn't be too upset about. And something is brewing on the MRRT front, with miners bristling at federal resource minister Martin Ferguson's comments that the commonwealth would not offset any future state royalty increases. There are many moving parts to this, not the least being potential for the greens to drive a harsher bargain if a satisfactory deal isn't voted through before the formation of a distinctly less mining-friendly Australian senate in July.

Oct. 27, 2010

BHP and Rio Tinto Friends No More

BHP and Rio Tinto terminated their proposed Pilbara iron ore production joint venture. Consummation of the deal was subject to a number of conditions, not the least being

Analyst Notes (continued)

regulatory approval. This was always going to be a tough task, given the number of jurisdictions involved. After extensive talks, including more recently with the German Federal Cartel Office, it was apparent that approval was unlikely. Rio Tinto and BHP will no longer pursue the joint venture and mutually agreed that no $275.5 million breakup fee is payable by either.

This was to be a deal reflecting common sense. It covered the entirety of both Western Australia iron ore assets in a 50/50 joint venture. The net present value on a 100% basis of shorter rail hauls, combined mining operations, blending opportunities, and management and overhead savings were calculated to be in excess of $10 billion. Production could have been ramped up more rapidly than on a stand-alone basis. It has come to naught, though there might still be opportunities to do deals on some assets. The problem is the majors are extremely wary of carrying third-party product on their 100% owned lines--paranoid about the prospect of open access and the risk that others' rail stock might pose for their vital infrastructure and scheduling.

For now, life goes on as usual. Our BHP numbers assumed the joint venture would proceed. Unwinding that outcome means future iron ore production decreases a tad. Next year's leverage for BHP will be lower with the $5.8 billion equalization payment to Rio Tinto no longer required. Despite all this, the impact on earnings and valuation is relatively minor. We did not include cost synergies in our numbers, and we were relatively conservative on the capital cost savings. The forgone savings from capital expenditure synergies does have some impact. Infrastructure spending will now necessarily be duplicated.

And what of these regulators in far-off lands? Couldn't BHP and Rio Tinto have just gone ahead and let them lump it? After all, where else were they going to get the iron ore from? The European Union was the key player, with others like the German Federal Cartel Office feeding into its decision. They were responding to the concerns of their constituent steel mills around the concentration in ownership of iron ore supply. BHP wasn't willing to speculate as to what remedies the EU and others could have sought. At the very least, it could have included requirements to sell certain assets; at the worst, restrictions on trade. Both BHP and Rio Tinto have assets in Europe and other jurisdictions and decided not to open that can of worms.

We remain positive on BHP.

Oct. 15, 2010

BHP: A Wolf in Sheep's Clothing?

Why would BHP CEO Marius Kloppers express support for a carbon tax? The mining industry has its fair share of climate skeptics. Geologists and model-based climatologists have very different views of the world. Does BHP stand to gain or lose from a carbon tax? Marius Kloppers himself has circa two million shares at stake. This excludes future grants as part of his remuneration package.

BHP is a diversified company, a structure designed to smooth volatile commodity earnings streams. This strength was demonstrated in the recent global downturn--weaker aluminum and copper prices were offset by rampaging iron ore and metallurgical coal prices. It is likely that this diversification could again prove at the very least a partial hedge against a carbon tax. It is a feature many competitors don't enjoy.

Analyst Notes (continued)

Carbon-heavy energy coal is not a major component of BHP's earnings stream. Base metals, already tight, might benefit from the necessary electrification associated with growth in renewable energy sources. BHP has substantial gas interests, a potential winner versus other more carbon-intensive hydrocarbons. The company's oil interests sheltered it from the impost of sky-rocketing oil prices on other divisions in 2008. Growth in worth of gas assets might achieve some of the same under a carbon tax.

BHP is also a low-cost producer, a function of a portfolio replete with Tier one assets. It is best placed versus peers to withstand a carbon tax. Pricing power in some areas, including traded iron ore, could even allow a substantial component of costs to be passed on to customers.

What about Klopper's call for Australia, a drop in the ocean of global carbon emitters, to unilaterally lead the world in taxing carbon? Well from BHP's perspective it might not be devastating. Around one third of earnings, 45% of assets, 60% of employees and 40% of taxes are non-Australian. Australian operations would move up the cost curve and pressure prices up. But offshore operations would improve relative to Australia's loss until such time as a level playing field was reinstated. These are operations that aren't subject to the Gillard Government's proposed minerals resources rent tax (MRRT).

And finally BHP has an interesting little asset called Olympic Dam in South Australia where it is considering a major series of upgrades. Expanded Olympic Dam output would exceed one quarter of global mined uranium. This is the one low carbon energy source with the capacity to fuel meaningful baseload global electricity. There are hundreds of new reactors slated for the coming decades and uranium's contribution to running costs is small. Olympic Dam is the world's largest known uranium deposit, alone housing 40% of the planet's resources. That's one hell of a call option on a re-rating in uranium prices. Moreover, the exemption of copper, uranium, gold, and silver from the proposed MRRT potentially enhances Olympic Dam's appeal versus iron ore and coal projects.

BHP Billiton Limited BHP

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
62,354	278,915	Industrial Metals & Minerals	Basic Materials

BHP Billiton is a diversified miner that supplies aluminum, coal, copper, iron ore, mineral sands, oil, gas, nickel, diamonds, uranium, and silver. A 2001 dual-listed merger of BHP Limited (now BHP Billiton Ltd.) and Billiton PLC (now BHP Billiton PLC) created the present-day BHP Billiton. The two still operate as separate firms but are overseen by the same board and management team. Shareholders in each company have equivalent economic and voting rights in BHP as a whole.

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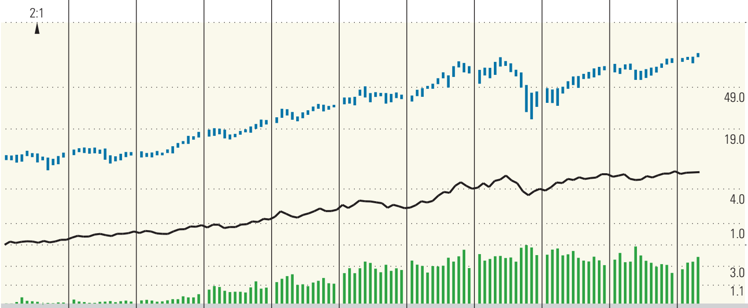
Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
★★★	99.80	89.00	Medium	Narrow	—

per share prices in USD

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	
12.01	12.95	18.49	24.38	34.48	50.74	87.43	95.61	78.75	93.56	104.59	Annual Price High
7.56	8.90	10.27	15.57	22.58	33.45	36.37	24.53	33.09	58.38	83.85	Low
2:1											Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500

52 week High/Low
104.59 - 58.38

10 Year High/Low
104.59 - 7.56

Bear-Market Rank
9 (10=worst)

Trading Volume Million

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	Stock Performance
7.9	9.9	61.5	33.5	41.5	21.1	78.6	-36.8	82.3	23.6	8.4	Total Return %
20.9	33.3	35.1	24.5	38.5	7.5	75.1	1.7	58.9	10.8	3.5	+/- Market
-6.4	-242.4	-109.7	3.0	-1.7	1.6	-17.0	16.8	-3.4	-2.2	8.7	+/- Industry
2.4	2.4	1.7	1.5	1.7	1.8	1.3	3.3	2.1	1.9	1.8	Dividend Yield %
64517	42836	56751	74794	101198	115785	200453	119894	214021	259687	278915	Market Cap USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Financials
11467	17062	16549	23513	29587	32153	39498	59473	50211	52798	62354	Revenue USD Mil
36.4	44.5	44.6	48.3	50.0	50.2	67.0	39.5	76.1	79.9	83.0	Gross Margin %
1580	2876	3128	4636	8382	14671	18401	23150	12688	21527	26922	Oper Income USD Mil
13.8	16.9	18.9	19.7	28.3	45.6	46.6	38.9	25.3	40.8	43.2	Operating Margin %
1024	1648	1900	3403	6398	10450	13416	15390	5877	12722	17111	Net Income USD Mil
0.27	0.41	0.50	0.86	2.08	3.45	4.58	5.50	2.11	4.56	6.12	Earnings Per Share USD
0.26	0.26	0.29	0.33	0.46	0.64	0.77	1.12	1.64	1.66	1.74	Dividends USD
3861	3981	3800	3957	3076	3031	2929	2802	2799	2798	2795	Shares Mil
—	—	4.20	4.61	5.80	9.61	10.79	13.87	15.72	20.07	20.07	Book Value Per Share USD
2553	3724	3627	5310	8688	10476	15595	18159	18863	17920	24645	Oper Cash Flow USD Mil
-1003	-2359	-2571	-2589	-3831	-6005	-7176	-8924	-10735	-10656	-11230	Cap Spending USD Mil
1550	1365	1056	2721	4857	4471	8419	9235	8128	7264	13415	Free Cash Flow USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Profitability
6.3	7.4	6.5	11.3	17.5	23.1	25.1	23.0	7.6	15.2	19.0	Return on Assets %
17.4	17.9	14.9	24.4	39.7	50.5	49.8	45.3	15.0	28.8	34.2	Return on Equity %
8.9	9.7	11.5	14.5	21.6	32.5	34.0	25.9	11.7	24.1	27.4	Net Margin %
0.71	0.76	0.56	0.78	0.81	0.71	0.74	0.89	0.65	0.63	0.69	Asset Turnover
2.6	2.3	2.3	2.1	2.5	2.0	2.0	2.0	2.0	1.8	1.8	Financial Leverage

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	06-10	Financial Health
97	-314	0	1627	883	-85	838	5202	10636	12092	12092	Working Capital USD Mil
3192	6383	195	5453	7971	7594	9244	—	15512	14042	14042	Long-Term Debt USD Mil
5613	12821	12761	15078	17153	24218	29667	38335	39954	48525	48525	Total Equity USD Mil
0.57	0.50	0.02	0.36	0.47	0.32	0.31	—	0.39	0.29	0.25	Debt/Equity

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Valuation
39.2	34.0	31.9	19.2	10.1	9.7	15.0	10.0	22.8	15.2	16.3	Price/Earnings
—	—	—	—	—	—	—	—	—	0.9	1.0	P/E vs. Market
3.9	3.0	3.6	3.4	2.4	3.4	4.7	1.9	4.8	4.2	4.5	Price/Sales
—	—	4.3	5.2	5.8	4.1	6.5	3.1	4.9	4.6	5.0	Price/Book
10.4	13.5	16.8	13.3	7.6	9.1	12.2	5.0	18.7	10.5	11.3	Price/Cash Flow

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	5.2	10.2	12.3	15.2
Operating Income %	69.7	5.4	20.8	64.0
Earnings/Share %	116.1	-0.2	17.0	24.2
Dividends %	1.2	29.2	29.3	18.7
Book Value/Share %	20.9	18.8	25.1	—
Stock Total Return %	24.7	9.6	19.9	27.4
+/- Industry	10.5	11.7	5.7	-17.4
+/- Market	15.8	10.0	19.4	26.1

Profitability Analysis

Grade: D	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	34.2	37.9	5.7	22.6
Return on Assets %	19.0	18.8	3.0	8.5
Fixed Asset Turns	1.1	1.1	1.0	7.3
Inventory Turns	2.0	4.7	3.3	14.4
Revenue/Employee USD K	1575.8	1328.1*	—	937.4
Gross Margin %	83.0	62.5	62.3	40.2
Operating Margin %	43.2	39.4	33.7	14.7
Net Margin %	27.4	25.6	5.5	10.0
Free Cash Flow/Rev %	21.5	16.1	18.6	0.1
R&D/Rev %	—	—	—	9.9

Financial Position

Grade:	12-09 USD Mil	06-10 USD Mil
Cash	12456	12456
Inventories	5334	5334
Receivables	6732	6732
Current Assets	25134	25134
Fixed Assets	55576	55576
Intangibles	687	687
Total Assets	88852	88852
Payables	8152	8152
Short-Term Debt	2191	2191
Current Liabilities	13042	13042
Long-Term Debt	14042	14042
Total Liabilities	40327	40327
Total Equity	48525	48525

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	16.3	14.6	17.5	16.4
Forward P/E	10.0	—	—	13.4
Price/Cash Flow	11.3	11.1	14.9	8.5
Price/Free Cash Flow	20.8	39.5	24.0	18.0
Dividend Yield %	1.8	—	2.3	1.8
Price/Book	5.0	4.6	3.5	2.2
Price/Sales	4.5	3.8	4.5	1.4
PEG Ratio	0.6	—	—	1.8

*3Yr Avg data is displayed in place of 5Yr Avg

Quarterly Results

Revenue USD Mil	Sep 09	Dec 09	Mar 10	Jun 10
Most Recent Period	—	—	—	—
Prior Year Period	—	—	—	—

Rev Growth %	Sep 09	Dec 09	Mar 10	Jun 10
Most Recent Period	—	—	—	—
Prior Year Period	—	—	—	—

Earnings Per Share USD	Sep 09	Dec 09	Mar 10	Jun 10
Most Recent Period	—	—	—	—
Prior Year Period	—	—	—	—

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
BHP Billiton Limited	278915	62354	16.3	34.2
Vale S.A.	172325	36697	8.3	24.3
Rio Tinto PLC	139321	56576	9.7	28.0

Major Fund Holders

	% of shares
Fidelity Diversified International	0.25
Fidelity Advisor Diversified Intl A	0.03
Permanent Portfolio	0.03

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

Morningstar Research Methodology for Valuing Companies

Competitive Analysis → **Economic Moat™ Rating** → Company Valuation → **Fair Value Estimate** → Uncertainty Assessment → ★★★★★

Competitive Analysis: Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade-show visits
- Competitor, supplier, distributor, and customer interviews

Economic Moat™ Rating: The depth of the firm's competitive advantage is rated:

- None
- Narrow
- Wide

Company Valuation: Analyst considers company financial statements and competitive position to forecast future cash flows.

Assumptions are input into a discounted cash-flow model.

Fair Value Estimate: DCF model leads to the firm's Fair Value Estimate, which anchors the rating framework.

Uncertainty Assessment: An uncertainty assessment establishes the margin of safety required for the stock rating.

★★★★★:
★
★★
★★★
★★★★
★★★★★
The current stock price relative to fair value, adjusted for uncertainty, determines the rating.

economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow
This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate
We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value
This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty
To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety
This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling
The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades
We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."