South32 is the new diversified resource company spun off from BHP Billiton and will start trading on Monday 18 May. Holders of BHP Billiton will receive 1 South32 share for each BHP Billiton share held by way of an in-specie dividend. The last day on which BHP Billiton shares will trade with an entitlement to South32 will be 15 May.

About the company:

South32 will house about a third of BHP Billiton’s current operations and will consist of 12 assets or joint ventures in five countries. It will produce 7 different commodities namely Aluminium, Alumina, Nickel, Manganese, Thermal Coal, Met Coal and Cannington (a combination of Silver, Lead and Zinc).

Geographic lay-out:

The bulk (59%) of the company’s earnings will come from Australia with Southern Africa at 29% and South America with 12% through operations in Columbia and a non-operated JV in Brazil.

South32 EBITDA breakdown (%):

The company is a strong earnings and cash generator, even at the current subdued commodity prices, although spot prices will see a 20% drop in earnings for the 2016 financial year according to Macquarie estimates. This continues into 2017 and 2018 with both years’ earnings having 26% downside when using current spot commodity prices. Macquarie’s NPV at spot of $9.75bn is also 30% lower than their estimated NPV of $14bn.

The assets have delivered combined underlying EBITDA of more than $2bn per year over the last decade with an average EBITDA margin of 36% over
decade with an average EBITDA margin of 36% over this time period. South 32’s portfolio of assets made a pre-tax profit of $422m in 2014 on revenues of $10.4bn.

Historical combined underlying EBITDA and margin ($bn and %):

Source: South32 Roadshow presentation. Figures based on FY2014.

The expectation of improving commodity prices should see the EBIT and EBITDA margins improve over the next few years. Macquarie expects the EBITDA margin to rise from 18% in FY14 to 26% in FY15 and c.30% in FY16 which it should then maintain till FY20.

Cash from operations has significantly exceeded capital expenditure with net operating cash flows before financing activities and tax and after capital expenditure of $1.4bn in FY2014.

Historical combined cash generation and capex ($bn):

Source: South32 Roadshow presentation.

Morgan Stanley’s current expectations have revenue for FY16 coming in around $7.74bn and EBIT of $1.11bn. Aluminium and Alumina are the largest contributors to revenue with $1668mn and $1707mn as well as EBIT with $735mn and $433mn.

When we compare this to likely revenue and EBIT at current spot commodity prices, it is clear that there is large downside risk to these estimates especially from an earnings perspective. At spot prices revenue is 4% lower at $7.48bn and EBIT 55% lower at $495mn.

Macquarie gives a good comparison between South32 and its London listed peer group where their expected 2015 PE ratio of 14.4x is more or less in line with that of the peer group’s average of 14x and the EV/EBITDA ratio comes in below the average of the peer group.

They also compared South32 to Glencore, the only other non-iron ore major, and have South32 coming in slightly more expensive at a multiple of 14.4x for 2015e, 10.7x for 2016e and 9.7x for 2017e while Glencore is 13.5x for 2015e, 8.9x for 2016e and 7.1x for 2017e.

South32 has a strong balance sheet and an investment grade credit rating and this will remain core to management’s strategy moving forward. Opening net debt will be $0.7bn with closure and rehabilitation provisions of $1.5bn which will also be transferred.

There is significant liquidity from day one with a $1.5bn revolving syndicated bank facility. Along with the strong balance sheet this provides the financial strength and flexibility to pursue investments that meet strict financial criteria.
With limited options for growth among current assets and an average mine life of about 13 years, the new company will need to consider acquisitions and will be a potential takeover target in itself. There is already some speculation that X2 Resources, which was started by former Xstrata CEO Mick Davis, and Glencore may have South32 in its sights.

**The listing**

The primary listing will be on the Australian Stock Exchange with a standard listing on the London Stock Exchange and a secondary listing on the Johannesburg Stock Exchange. This is different to BHP Billiton which will continue to have a dual listed structure with the Ltd shares being primary listed in Australia and Plc shares holding a primary listing in London with a secondary listing in Johannesburg.

South32 will not be eligible for index inclusion in FTSE indices because of the London listing being a standard listing. This will mean that some investors in BHP Billiton will be unable to hold South32 due to their investment mandates. The implication of this is that default selling could place the share under short term pressure post the spin-off from BHP Billiton.

For shareholders on the JSE, the rules state that 15% or more of the company must be held by South Africans in order for it to be eligible for inclusion in an SA index. Currently 8% of the total BHP Billiton share register is held by South Africans (this is for Ltd and Plc shares combined), however as a percentage of only the Plc shares this percentage increases to 20%. This implies that South32, which will be roughly 8% held by South Africans, will not be eligible for South African index inclusion while BHP Billiton continue to be part of the different indices. There is, however, the possibility of index inclusion in the ASX Top50 or even Top20 if the market cap is above AUD13bn.

Looking at possible listing prices, Morgan Stanley Research estimates that it is most likely to be between R22-R25 for the South African listing. This will put the share on a FY16 PE multiple in the region of 12-15x.

Once again we if we take the spot commodity prices for this scenario, we get substantially different PE numbers. For the same region of a c.R22-R25 share price, Morgan Stanley get a FY16 PE multiple of c.46-51x when using spot prices.

**Positives:**

- Unique commodity mix which are mostly low cost and expandable.
- Strong balance sheet with very little debt and opportunity to gear up.
- No iron ore exposure.
- Strong corporate appeal. The lowly geared balance sheet very possibly makes this asset an acquisition target for other mining majors looking to bulk up their portfolios.
- Minimum of 40% dividend pay-out.

**Negatives:**

- Electricity concerns in South Africa. This could be of particular risk to Hillside given it is such a big consumer of power, but on the flipside Eskom finds this contract quite useful as a “swing” source of on/off supply when they do need to cut power to the grid.
- Average mine life of only 13years.
- Labour issues in South Africa.
- The commodity cycle may still be on the downturn.
- Political risks in South Africa and South America.

**Conclusion:**

South32 is a solid company with a strong balance sheet and potential to generate cash. The 40% minimum dividend pay-out policy as opposed to a progressive policy means the company will be able to invest throughout the cycle and especially when commodity prices are low and it is cheaper to invest.
Analysis continued

South32 will provide South African investors with another option alongside Glencore to invest in a diversified mining company that doesn’t produce iron ore. It will also be the only major diversified miner that doesn’t have exposure to either iron ore or copper and may be the long awaited alternative.

We are not positively disposed to the resources sector and don’t see much upside for commodity prices in the short to medium term, but in an out of favour sector we have South32 as a top pick alongside BHP Billiton. It is difficult to get a good feel of the valuation pre-listing with no share price, but we believe this share will follow in the same footsteps as the other major diversified miners in the sense that they are expensive at spot commodity prices and that the market is pricing in that commodity prices will recover over the next year.

The unique commodity mix and lack of exposure to iron ore and copper provides a welcome alternative and something South African investors never had an option of. We also believe that the company is a potential take-over target for companies such as X2 and Glencore and could attract a premium rating for this reason.

FJ Veldman