

**METALS AND MINING RESEARCH**
**August 8, 2017**

# Rio Tinto, PLC

## A Deluge of Free Cash Flow

### KEY TAKEAWAYS

Rio remains one of our two Overweight rated picks. We like boring. As a low cost producer of both iron ore and aluminium, Rio continues to generate very attractive levels of free cash flow in these core businesses. We are neutral on the outlook for aluminum prices. And, we share the market's perception that iron ore prices are elevated. However, Rio's cash costs and maintenance capex are so low in these core businesses that we are confident Rio can generate attractive levels of free cash flow for decades in any conceivable commodity price environment. Plus, as we have discussed, nobody is more bullish than us with regard to the sustainability of high copper prices over the next decade. Despite copper being a smaller part of Rio's mix, we believe Rio shares are an attractive way to leverage the bull market we foresee in copper.

There are some who argue that Rio shares cannot perform well if iron ore prices decline. In over two decades covering the sector, we have seen numerous examples where mining equities perform inversely to the underlying commodities. Indeed, our signature call on gold stocks (long gold/short gold miners) has worked well despite being counterintuitive. Valuation matters.

On our estimates, Rio could comfortably double its 5% dividend and have zero net debt by 2020. Or, the company could maintain the dividend and complete \$2B of accretive share buybacks per annum – and still be net debt zero by 2020. Candidly, balance sheets that are too clean can be cause for concern. Too often, mining acquisitions are dilutive to the acquiring company's shareholders. We greatly prefer the lower risk acquisition of a company's own shares. So far, the actions and statements of Rio's management have given us comfort. We raise our 1-year target to 4200p.

### RIO:LN: Quarterly and Annual EPS (GBP)

FY Dec	2016A	2017			2018		
		Old	New	Cons	Old	New	Cons
2Half	N/A	NC	N/A	N/A	NC	N/A	N/A
2Half	N/A	NC	N/A	N/A	NC	N/A	N/A
Year	2.68A	3.89	4.57E	4.20E	4.38	4.83E	3.46E

Source: Renaissance Macro Research  
 Consensus Estimates are from FactSet

Refer to page 3 for important disclosures and Analyst Certification. RenMac and its affiliated companies do not seek to do business with the companies covered in this report. RenMac does not make a market in the security. The analyst does not own shares in the security.

### Ratings

Stock Rating: Overweight  
 Industry View: Neutral  
 Target Price: £42.00

### Financial Data

Symbol: RIO:LN (NYSE)  
 Rating/Target Price: OW / £42.00  
 Price (08/07/2017): £36.30  
 52-Week Price Range: £22.30 - £37.47  
 Diluted Shares Outstanding (mm): 1,797  
 Market Cap (mm): \$84,800  
 Average Daily Vol (mm): 4.8  
 Book Value/Share: \$26.18  
 Dividend/Yield: 5.3%  
 Net Debt (mm): \$8,102

### Price Performance

#### Price Performance



RIO:LN  
 Source: FactSet

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**Rio Tinto, PLC**

**Stock Price (Pence)** 3630p  
**Rating** Overweight  
**Price Target** 4200p

**Shares (mm)** 1H17 1,797  
**Market capitalization (GBP mm)** £65,231  
**Market capitalization (\$ mm)** \$84,800

**Financial Summary (US\$ mm)**

Cash 1H17 \$7,746  
Total Debt 1H17 \$15,848  
Net Debt 1H17 \$8,102  
Common Equity 1H17 \$42,291  
Total Debt / Capital 1H17 27%  
Net Debt / Capital 1H17 14%  
Net EV/EBITDA 2017E 4.9x  
P/E 2017E 10.3x  
Annual Dividend 2017E \$2.50  
Dividend Yield 2017E 5.3%



**Consolidated EBITDA by Business Unit**

	2014	2015	2016	2017E	2018E	2019E	2020E	2021E
Iron Ore	14,244	7,872	8,859	11,428	10,579	10,002	9,440	9,440
Aluminium	2,930	2,742	2,472	4,009	4,685	4,885	4,701	4,664
Copper	2,336	1,495	1,148	1,857	2,599	3,157	3,317	3,855
Coal	399	492	893	1,179	767	565	647	647
Diamonds & Minerals	1,154	833	834	968	930	951	961	971
Other	-1,240	-794	-696	-794	-715	-715	-715	-715
<b>Total Underlying EBITDA</b>	<b>19,823</b>	<b>12,640</b>	<b>13,510</b>	<b>18,647</b>	<b>18,845</b>	<b>18,845</b>	<b>18,351</b>	<b>18,862</b>

Iron Ore Price- Fines (US\$ per tonne)	\$98	\$56	\$56	\$68	\$64	\$62	\$60	\$60
Copper Price (US\$ per pound)	\$3.10	\$2.49	\$2.17	\$2.69	\$3.00	\$3.50	\$3.50	\$3.75

**Financial Data**

Underlying EPS	\$5.10	\$2.21	\$2.68	\$4.57	\$4.83	\$4.94	\$4.83	\$5.14
P/E	9.3x	21.4x	17.6x	10.3x	9.8x	9.6x	9.8x	9.2x
Net EV/Consolidated EBITDA	5.0x	7.9x	7.0x	4.8x	4.4x	4.1x	4.0x	3.6x
Attributable EBITDA (\$ millions)	19,738	12,515	13,246	18,131	17,973	17,814	17,306	17,719
Net EV/Attributable EBITDA	5.1x	8.0x	7.2x	4.9x	4.6x	4.4x	4.2x	3.8x
Net Debt/Cap	0.18	23%	18%	8%	2%	N/A	N/A	N/A
Dividend per Share (\$)	\$2.15	\$2.15	\$1.70	\$2.50	\$2.30	\$2.40	\$2.50	\$2.60
Dividend Yield	4.6%	4.6%	3.6%	5.3%	4.9%	5.1%	5.3%	5.5%
Free Cash Flow per Share (Total Capex)	\$3.31	\$2.57	\$3.03	\$5.28	\$5.12	\$5.48	\$5.55	\$5.91
Free Cash Flow Yield	7%	5%	6%	11%	11%	12%	12%	13%

**Valuation**

We find Rio Tinto's valuation and financial position very attractive. The company's lowest quartile assets in both iron ore and aluminium will likely enable the company to generate very healthy levels of free cash flow even if commodity prices were to fall. Meanwhile, the company is well positioned to benefit from higher copper prices which we believe are likely over the next few years.

**Growth Prospects**

What we care about is growing the dividend and share buybacks. Management has done a remarkable job cutting costs and sustaining capex to between just \$2B to \$2.5B per year. At that level, we believe Rio Tinto will both grow the dividend and repurchase stock.

**Balance Sheet**

Rio has a very healthy balance sheet with a net debt/capital ratio of just 14%. Further deleveraging is unnecessary in our opinion.

**Investment Summary**

We recommend purchase of the stock. While we have low expectations for iron ore and aluminium price strength, Rio's low cost position will enable the company to generate robust free cash. The benefits of aggressive expansions of the past decade are bearing fruit. Maintaining a lean capex budget and humility toward the risks of acquisitions will be key. We like what we see so far with this management team.

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**Primary Stock:**

Rio Tinto, PLC (RIO:LN, 08/07/2017, pounds £36.30). Overweight

**Price target and Valuation Methodology:** Each Analyst has a single price target in all of the stocks that they cover. The price target represents that Analyst's expectation of where the stock will trade in the next twelve months.

We use an enterprise value multiple of estimated future EBITDA to arrive at our price targets.

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**Stock Ratings:**

**Overweight** – The stock is expected to outperform the un-weighted expected total return of the industry coverage universe over the next 12 months.

**Equal Weight** – The stock is expected to perform in line with the un-weighted expected total return of the industry coverage universe over the next 12 months.

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**Industry Rating:**

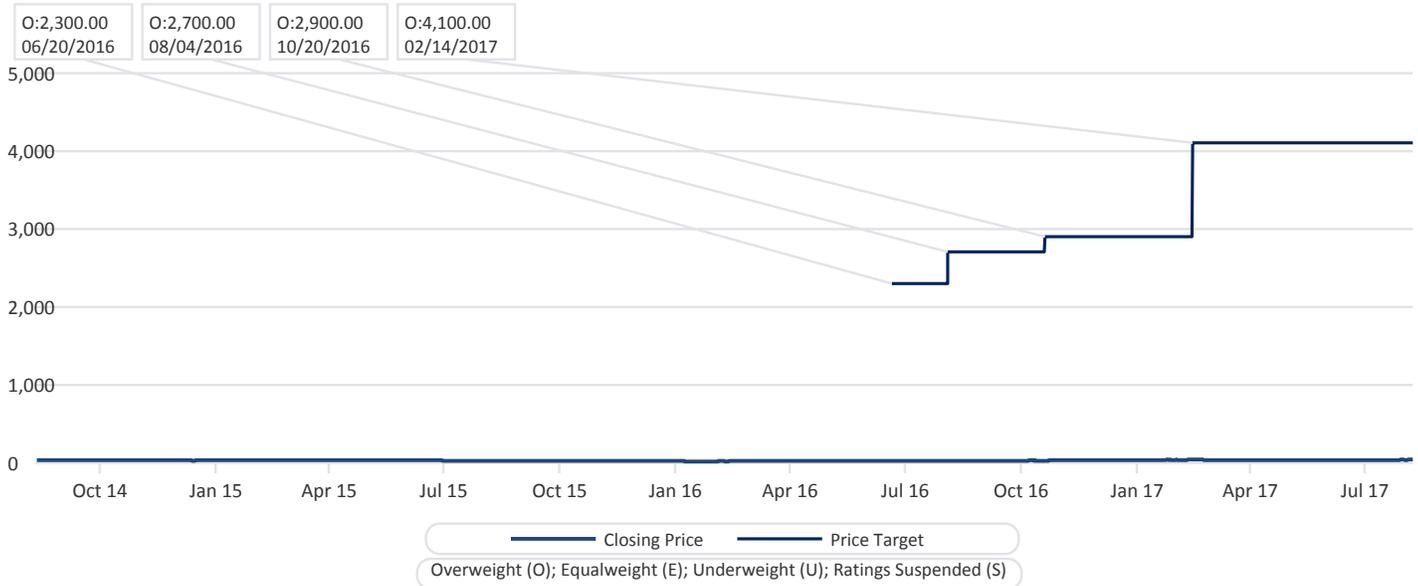
**Positive** – Industry coverage universe has improving fundamentals and valuations.

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**Rio Tinto, PLC Rating History as of 08/07/2017**

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