THE ALTERNATIVE VIEW

By Hugh Dive

AURORA FUNDS MANAGEMENT

SPLITTING UP!

This week marked the ASX debut of South32, the third major group of BHP assets (total value $14 billion) to be spun-off to its shareholders in the last 15 years. In its first week of trading, South32 has performed well (outperforming BHP by 11% adjusting for the split). Whilst this confounded predictions of weakness, we note that most of the gains occurred on Tuesday's session and pricing may be tested next week on the back of index-related selling from European investors. In this week's piece we are going to look at the rationale behind spinning out assets to form a new company, together with the other two spin-offs previously completed by BHP.

The Ignored Child gets a New Lease of Life

The most common reason cited for a company demerging or "spinning off" a division into a separately listed vehicle is that the previously unloved division will now be run by management totally focused on it. The theory goes that as a result of this increased love and focus and not having to compete with other larger divisions for management attention and capital, the demerged division begins to prosper. Furthermore management at the parent company benefit, as the more attractive "core" business is now re-rated upwards by the market and valued on a higher multiple. The sum of the two parts becomes greater than the original whole.

Recent examples of this can be seen in ***Orica***'s 2010 spin off of their paint division ***Dulux*** and ***Woolworth***'s spin-off in 2012 of a portfolio of shopping centres into ***Shopping Centres Australasia Property Group*** and ***Brambles'*** demerger of its underperforming data management business ***Recall*** in 2013. These three spin-offs have proved to be very successful with Dulux giving shareholders a total return of +129% vs Orica's loss of -15%. Similarly Shopping Centres has returned +51% since it was spun out of Woolworths in 2012, against a total return to Woolworths shareholders of 0%.

Brambles decided to spin-off ***Recall*** in mid 2013 after failing to find a buyer for its document management business. Shareholders that held onto their ***Recall*** stock have done well enjoying a total return of +82% after a takeover bid from US competitor Iron Mountain in late 2014, comfortably ahead of parent Brambles which returned +30%.

From meeting with the new management teams of post their demergers, it was clear to me that they exhibited a great deal of pride in the results of their own smaller companies. Furthermore as stand-alone companies both ***Dulux*** and ***Shopping Centres*** (both held by Aurora) were able to make acquisitions to grow their businesses, moves that probably would not have been approved if they were still competing with Orica and Woolworth's much larger Australian grocery and global mining services for capital.

South 32 Spin-Off Strategy

BHP though South 32 has created a new company with an initial market capitalisation of $11 billion listed on the ASX (with secondary listings on the Johannesburg and London exchanges) from the company's aluminium, Columbian nickel, manganese, silver, and Illawarra and South African coal assets. Those with sharp memories will recall that South 32's assets comprise the bulk of what Billiton Plc originally brought to the table in its 2001 merger with Australia's BHP Limited. A deal that subsequently proved to be significantly weighted in favour of Billiton's shareholders.

What remains with BHP will be the core assets in iron ore, petroleum, copper and metallurgical coal, which are generating the vast bulk of BHP's profits and have received the most capital expenditure in recent years. BHP's management expects that in time, the more focused core BHP will be re-rated higher by the market with possibly lower political risk without the South African assets.

Haven't we seen this Movie before?

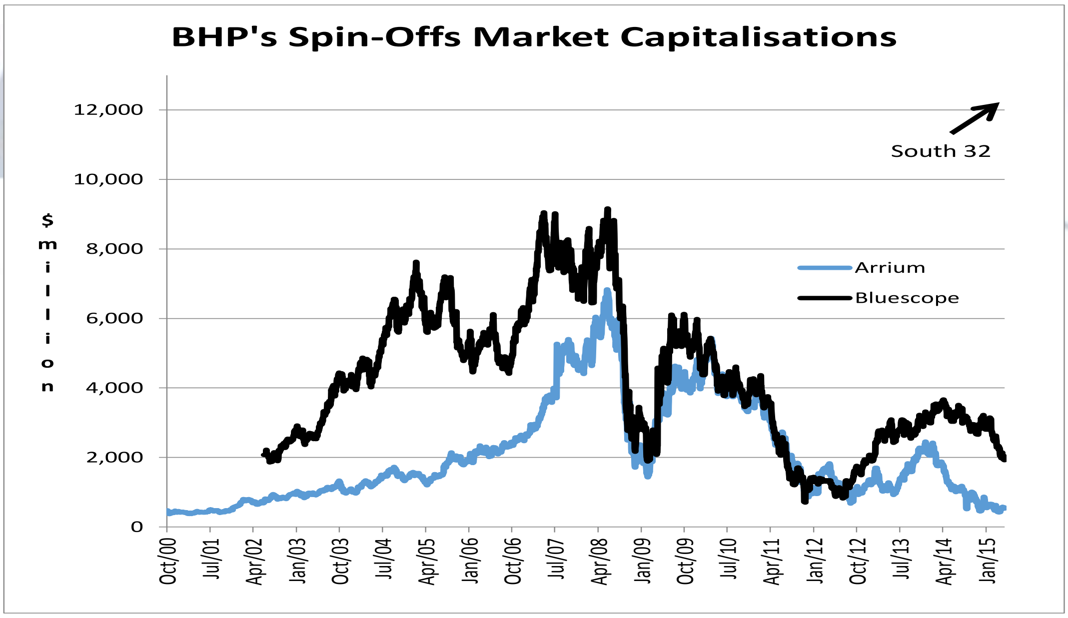
Whilst the above more recent spin-offs have all outperformed their parents, BHP has previously spun-off divisions in the past that they viewed as less desirable. In 2000 BHP demerged their long steel division (***Arrium*** *née* ***Onesteel***) and in 2002 their flat steel division ***BlueScope***. This was motivated by the view (which proved to be correct) that greater returns could be made from digging ore out of the ground and directly shipping it to China, rather than in manufacturing commodity steel in Australia. Furthermore BHP was able to "spin-off" the industrial relations headaches that are present in the heavily unionised steel manufacturing sector.

From the below table both spin-offs performed very well in the years post the spin-off, with Onesteel's market capitalisation rising from $400 million to $6 billion and BlueScope from $2 billion to $9 billion. Indeed the two co-operated in 2007 to takeover Smorgon steel for $2.5 billion.

During those heady years, BHP was criticised for letting go of their steel manufacturing businesses as it may face for spinning-off South32, however often the genius behind this course of action does not become apparent for several years.

In the period up until 2007, these two newly separated steel companies enjoyed the benefits of a low AUD and more importantly supernormal profits from being able to fix their material costs (iron ore and metallurgical coal) annually in a period of steadily rising steel prices. The breakdown of the annual iron ore contract system that had been in place since the 1960s in 2010 and the move to short-term prices has permanently removed this source of profits for the steel mills. Further as a result of dilutive share issues in the period between 2009 and 2012, BlueScope is now 70% below its initial 2002 issue price and Arrium 77% below its 2000 issue price in nominal terms!

The most consistent winner from spin-offs are the investment banks. BHP expect to pay US$115M in fees to create South32 and the investment banks also wet their beaks during the four major capital raisings that Arrium and BlueScope have made since 2009!



Whilst the above suggests that spin-offs can unlock hidden value for shareholders, there are downsides. Two separately listed companies results in the additional costs of maintaining two separate listings on the ASX such as two separate boards and management teams). Similarly to BHP's two other spin-offs, South32 has been given a good start with a lowly geared balance sheet. Aurora Funds are still holding onto our South32, we continue to monitor the position closely in light of BHP's previous success in removing problem assets from their portfolio.

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