Transcript

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Corporate Leaders Series

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Evan Davis

Good evening, everybody. Welcome to another in what is an occasional series – perhaps too occasional – of corporate leader conversations. I'm Evan Davis. It is my pleasure to welcome Sam Walsh here tonight. I think you'll probably know that he's the chief executive of Rio Tinto, a company worth $60 billion, employs 66,000 people, mostly in Australia, I think.

Sam Walsh

Australia, Canada, 45 countries.

Evan Davis

Revenues of about $50 billion. So we're talking a big company. I think I'm right in saying about half is iron ore now. Sam has been chief executive for two years. He's been in the company for a lot longer than that and was running the iron ore division, built it up very substantially through the good years in the iron ore cycle, in the noughties. He has a background in the motor industry and is a collector of antique milk jugs. Plenty to say about him.

Just to tell you what the format is today, we're going to have a conversation up here on stage for 20 or 30 minutes and then we'll open up to you to ask questions. We'll keep it informal and informative, Sam, if that works for you. This is an on-the-record event, no Chatham House Rule tonight. So you can tweet, using your silent mobile phones – it's always encouraged – with #CHEvents.

Sam, let's just start with the commodity price cycle. It always seems like people in the business are taken by surprise by the existence of this cycle, and they make all sorts of mistakes as a result of extrapolating from the present indefinitely into the future. Am I right in that perception?

Sam Walsh

Yes and no. I think people that have been in the industry long enough realize that it is cyclical. I guess we've just gone through a period of high prices for a range of commodities. I think particularly outside the industry, people have thought: well, hang on, this is going to continue forever. I can remember people commenting about the boom and how the boom will last forever. Well, people in the industry know that. If you look at how we make investment decisions at Rio, it's really on the basis of long-term prices, long-term forecasts for exchange rate and energy movements, rather than necessarily where we are today. So it's not as if you don't have line of sight as to where it's all heading.

Now, I think in getting to the basis of your question, there was a period when people were all chasing growth bubbles. One of my competitors put up a chart with bubbles. Bubbles were the theme of the day and everybody was trying to create bigger bubbles than the person next door. Unfortunately, like soap bubbles, some of them imploded on themselves. Almost every single company got burnt in one way or another through that process.

So it's not as if there wasn't an awareness that, hey, one day this is actually going to come off. But if you look at how Rio is positioned, our focus is on T1, Q1 assets – i.e., the lowest-cost quarter. That's so that you do actually manage your way through the cycles. So if you look at what's happening right now, the cycle is happening up here, and guess what? Our assets are down here. So we're very well positioned. That's really how you need to place your business.

Evan Davis

In terms of how Rio's positioned, I get a sense that you're a person torn in three different directions. For reasons that we'll talk more about, there's a kind of shareholder imperative – you don't want to be taken over. So there's a kind of, give money to shareholders. For reasons that are kind of good housekeeping in an industry that is so cyclical, you want to have a cautious balance sheet. And yet, you're someone who knows that you don't want to make the same mistakes as other people, so sometimes you want to be investing even though the price may be low. You may want to spend money on looking at good opportunities. So these are not compatible objectives: spending money on capex and –

Sam Walsh

I think they absolutely are, because they are driven by shareholder value. That's the fundamental that drives me. Fortunately, I'm aligned with our board. So shareholder value is important. Yes, you need returns to shareholders, but you also need growth. If you look at our forward plans, they will generate 5 percent copper-equivalent growth between today and 2019. I've not heard a single shareholder say: hey, Sam, 5 per cent doesn't work for us. It does actually work for them and it provides the growth that they're expecting, both in dividend but also in share price.

In relation to M&A type activity, again, it's all about value. I've said that if there's anybody out there – there's a few of my competitors here tonight – if they want to offer us more than we think something is worth, then of course we're going to consider it. Yes, we need to look at our strategy, we need to look at the positioning of our business. But it is all about value. Right now there's a big focus on one of my competitors, who is looking at spinning off some of their assets. Well, that's terrific. But if you look at our track record, we've actually divested of $17 billion worth of assets over the past five years. So the very process that they're going through now, with lots of fireworks and neon lights and what have you, we've actually already been through. We've already tightened our business. We've already gone through the portfolio analysis and divesting that we need to go through.

So I don't think it's incompatible at all, those three issues.

Evan Davis

Right, but you're not going to hand money to shareholders – you just announced a $2 billion buy-back.

Sam Walsh

And a 12 per cent increase in dividend.

Evan Davis

Sorry, I didn't mean to miss that out. But you're not going to hand money back to shareholders by degrading the balance sheet. That would be – or are you? You've got room. I think I saw it mentioned, there's balance-sheet capacity for handing money back to shareholders, which looks a bit like: let's do something a bit silly just in order to keep the shareholders happy.

Sam Walsh

I have a very simple way of looking at the business. I did note your comment earlier about us having a conservative balance sheet. We actually have a strong balance sheet. In an industry that goes through cycles, it makes absolute sense to have a strong balance sheet, because it positions the business for shareholder returns. It also positions the business if opportunities come up.

Having said all that, we have no plans for any major M&A. But if you look at the simple fabric of a business, in these days you need to run a business for cash. I know there will be accountants here who say it's all about earnings – well, with all due respect to the accountants here, and I do apologize in advance, there have been so many changes in standards and regulations and rules and what have you, that these days earnings aren't actually representative necessarily as to how a business is actually travelling. Cash, you can't debate. It's either in the bank book or it's not. It's a fundamental way of running a business.

Having focused you all on cash, you have your income coming in. In your case, it's your salaries, unless you're incredibly rich. If you are, why are you here? So you have your income coming in. That's the $50 billion that Evan referred to. Below that, you take out your costs of physically operating and your taxes and your royalties and everything else. It leaves you with your operating cash flow. On the other side, you have your outgoings, primarily the capital you're spending and the dividends. In a well-run business, you want to balance those two. You want to make sure, in the same way you do with your household budgets, that you're not actually spending more than you're earning, because that's a recipe for going out backwards.

Clearly, that's an important issue for us. Yes, your debt is going to go up and down. It physically will, in the same way that your credit card goes up and down. But you make darn sure that you can make the repayments. You make darn sure that you're not overextending yourselves. That's the position that we're in. If you want to get complicated about it – and this probably is for the accountants – we're aiming to have a debt to equity ratio in the range of 20 to 30 per cent. That's the best way of having a strong balance sheet. We finished last year with a debt to equity ratio of 19 per cent. By the time we've paid the buy-back and the 12 per cent increase in dividends, it will move us to 21 per cent. So we're in the lower part of the range. It actually means that we are in a great position.

As our move round shareholders, after we made our profit announcement Thursday of last week, I jokingly said: with a balance sheet like ours, with the cost savings and capital reductions and working capital reductions and everything else we've been working on, if we got to the annual results and we hadn't announced a material increase in shareholder returns, I probably would have been run out of this town. Because everybody would have looked at it and said: hang on, it's a lay-down [indiscernible]. Rio can afford to do what we're doing and the shareholders get that. As a result, share prices went up. People are pretty happy with what we're doing. But they're more happy with the fundamentals behind the way that we're running the business.

Evan Davis

We'll come to that, but let's go back to the commodity price cycle. It's a little more complicated than just one cycle, isn't it? Because iron ore, which is such a big part, thanks in large measure to your success at Rio running it –

Sam Walsh

Well, it was a team effort, but yes. I did have a few helpers.

Evan Davis

That one peaked really quite a long time ago, didn't it? Did it not hit the high in 2011, quite a long way before the others?

Sam Walsh

Yes, it did, but the truth of the matter is, any smart people in the industry actually knew that with the commitment to projects, that price would come off. Again, I emphasize that we invest for the long-term. Whether it's iron ore or copper, aluminium, diamonds, energy, any of our businesses, we're focused on the long-term. We're focused on the long-term demand. We're incredibly lucky in our industry that the world can't actually develop without what we supply. You can't have urbanization, you can't have industrialization. You can't have China, India, the Asian nations, the Middle East, Africa, South America, UK – you cannot physically develop without the fundamental building blocks that we supply. Even those mobile phones that I hope you've put on silent – even those have our raw materials in them. So this is a very fundamental part of it.

If you look at our iron ore business, we are the lowest-cost producer in the world. I've said that many times and nobody has sort of said, Sam, you're wrong, so I've got to be right. Our current cost of production, if you take into account the current exchange rates and the current energy prices, a unit cost, cost per tonne, cash cost: $17/tonne. Today we're selling for about $65/tonne. There are people that say: Sam, you should stop that. Well, the difference for me between $17 and $65, that's a pretty darn good margin. I agree, it's not as good as it was when it was $150/tonne selling price, but it's an incredibly good margin, and as the lowest-cost producer, the economists among you will say: Sam, you should be the last person that takes capacity off. And that's absolutely true.

So when people say this, they're actually thinking of people who are on the fourth quartile, and they're saying those are the people that should take the capacity off. For some confusing reason, people look at us and say, well, it should be Rio. No, we should be the last people. By the way, by that stage, the world has ended, so it will be the least of our worries.

Evan Davis

Short of the world ending, how worried are you particularly, I suppose, about the Chinese economic slowdown, which has obviously been quite a big driver of the fall in prices in the last couple years?

Sam Walsh

The slowdown we're seeing is actually good news. It actually means that China is being highly successful and it's actually moving from a developing economy more to a developed economy. Certainly if you look at the debates and issues that are going on in China, they are the sort of issues that worry us here or worry people in the US and Europe and so on, in terms of helping the underprivileged, the environmental performance, safety performance, community engagement – all those types of issues. So last year, China's GDP growth was 7.4 per cent. Yes, they were aiming for 7.5, they missed it by 0.1 – but I think they're the only economy that came so close to their target.

This year, we believe that the GDP growth will be around 7 per cent. More importantly, if you go into the fabric behind those numbers and how it impacts on my business across all of my commodities, urbanization – China is 54 per cent urban. The pundits, the economists are saying it will move to 70 per cent, which mirrors what's happened here, in the US, Europe and elsewhere. So there is a huge amount of construction and, dare I say, a huge movement in terms of moving into the middle class, moving out of poverty, that actually comes with that. That is a truly good thing.

But for those of you who are worried about China – and I'm not, but for those of you who are – I don't know if you've noticed that India has now surpassed China. Prime Minister Modi, full of promise – a few electorate issues in recent times – but this man is on the move. This man will actually make a difference. If you look at the reforms that have gone through, if you look at how he's targeting industrialization and growth, that will have a huge impact. Not at the same rate as China – it's a democracy. They picked up their systems from here and fiddled with it a bit and made it a little bit unwieldy. But Prime Minister Modi is a mover and shaker. I attended the Vibrant Gujarat Summit in early January, and he had 2,500 people in this room who were all very focused on what can they do to improve growth, made in India – what can they physically do? If you think, well, who were they – John Kerry, the secretary-general of the United Nations, the head of the IMF, the head of the World Bank, the head of the International Finance Corporation (oh, and Sam Walsh). Sorry, there were a lot of other important people.

Evan Davis

You're just name-dropping now, Sam.

Sam Walsh

They were very focused on what it actually takes. But if you look beyond India, as I mentioned, Asia, the Middle East, South America, Africa – some people, when I first started talking about Africa, said, hang on, Sam, get real. There's a billion people in Africa and they're going to want exactly what the rest of the world has got. Their telephone systems have actually jumped from hardwired lines to mobile phones. They get it. They can access the web, they can see what's happening and they want part of it.

So there will be further industrialization and that's just wonderful for a business like mine. But yes, it will still be cyclical.

Evan Davis

I'm getting the impression you see glasses as half-full always, all over the place.

Sam Walsh

Oh, yes.

Evan Davis

Let's talk about consolidation. You kind of referred to it a little bit earlier. You've rebutted takeover offers from Glencore and BHP as well. Some of those – the Glencore one, might say there was a kind of financial motive there or there were all sorts of rationales. But I'd like you to let me know what you think about the strategic – whether fundamentally there are economies of scale in the business. At a really operational level, does it make sense to be big?

Sam Walsh

Clearly, it does. Clearly, depending on your assets – if they're T1, Q1 assets – yes, it makes sense. If you have a larger scale, then you do have economies of scale. In a business like ours, by having central purchasing, having central shipping, yes. You probably don't know that we're the largest shipper, shipping company, in the world. We do a lot of logistics. This is by tonne, it's not by ships. It is important that you position the business in that way.

But let me come back: it's all about value. The reason that deals don't work, whether they are big deals or little deals, is because the value is not being offered. We've sold $17 billion worth of our assets and that's because we got value for the assets. This was not a fire sale or market day at the grand bazaar, this was based on value. When I took over, I took a couple of our items that were up for sale off the market. I took part of our aluminium business off the market and I took diamonds off the market. Thank god I did, because they weren't being offered value. If you want a real measure of whether I was right or wrong, all the auditors indicated that we needed to write up those assets by $1 billion. Let me tell you, shareholders would not have thanked me. So it gets back to value.

Evan Davis

But if there are these great synergies and if scale is important, it should be possible to find value in mergers, right?

Sam Walsh

Yes.

Evan Davis

You may say the people offering us are not offering a decent price that gives us value, but it should be possible to sit down, negotiate and work out a value, if scale is important. That's before we get to the whole issue of whether jurisdictions around the world would let two of the largest four or five mining companies combine. I have my doubts about that.

Sam Walsh

The interesting thing is that – the media are sort of infatuated with this, and I guess it's because it sells newspapers or gets people watching TV or what have you. But as I move around investors, investors say: I don't get it. Why are you giving this any ear? Because it actually isn't going to happen. Now, part of the reason is value. Part of the reason is, as you say, the antitrust and people who collect tax and what have you, they're just simply not going to let it happen. At the end of the day, the BHP potential takeover of Rio fell over primarily because of value – but it fell over because the antitrust authorities said: we are not going to let this happen. Simple as that.

Evan Davis

I'll open it up to the floor in a moment. We should just talk a little bit about the relationship between your industry and the public and the governments in the countries in which it operates. It's an industry that I suppose lends itself to question marks. I don't suppose a day goes by without you having some NGO on your back saying you're doing this wrong or this is not reasonable. It's also an industry that has a slightly bad reputation, doesn't it, for corruption scandals here or bribes there. Am I right in thinking it's inevitable in an industry where so much of what you're going to acquire are assets that are granted at the behest of governments – dictators, often; many in dodgy parts of the world – that it's an industry that is particularly vulnerable to these kinds of concerns?

Sam Walsh

Yeah. Look, there are good guys and bad guys in any industry. We certainly got our share of characters in the mining industry. A group of the most responsible mining companies in the world created the International Council of Mining and Metals some 12 years ago. It was really created because there weren't standards. There was not a way that you could tell the good guys from the bad guys, because we all got branded by the last bad guy that did something that created horror out in consumer land.

But the good guys are very focused on ensuring that we position the business so that we are doing the right thing, that we are good corporate citizens, that we are putting money back into the community, that we are providing jobs, that we are providing business opportunities for people. If you look at our business, 85 per cent of our business is in OECD countries. So I wouldn't exactly call them dodgy. Fifteen per cent is primarily in Guinea and Mongolia. Both of those projects, when they come to fruition, are going to add stunning value to the people of those countries.

In the case of Oyu Tolgoi in Mongolia, by the time the open-cut and the underground is operating, it will add a third to the GDP of the country. It will add thousands of jobs. It will support businesses and trade and it will help the government of Mongolia build the infrastructure and build the projects that the country desperately needs. In Guinea, in West Africa, there's a similar project that will actually double the GDP of that country. Thousands of jobs.

Evan Davis

A lot of history to that project.

Sam Walsh

There's a lot of history to it. But importantly, this is about companies like us actually positioning ourselves so that we can make a difference. One day in the future, when I retire – not currently – one day, when you look back, it won't be the fact that you built monuments or you've got awards or what have you, it will be actually, what have you actually done to make a difference in the world? What have you done to make the world a better place? I always spend $280 million a year with our local communities. Some of it is focused on improving education, building schools, helping with education programmes. Part of it is about health and elderly care and building hospitals, working to improve. Anti-malaria campaigns, nutrition campaigns. Help fighting Ebola in Guinea, as you mentioned. We contributed with real substance to that fight, we didn't just write a check. We actually handed over vehicles that we had, we handed over tents and what have you. We handed over kits that would help people avoid Ebola. Sitting here today, thank god none of our 2,000 people caught Ebola and none of their families caught Ebola. I'm not sure that every mining company operating in West Africa can actually say that.

That's important in terms of putting back into the communities. You're right that – people think that governments actually represent the people. They do in a way, but they're communities also, and the communities round our mines want their say, they want their involvement. They want to see their standard of living increase. That's why Rio Tinto each year issues a taxes-paid report. We believe in total transparency to the tax we pay. In 2013, worldwide, we paid $7.5 billion in taxes and royalties. Every single payment we made to government, at whatever level, was in the taxes-paid report so that the people of those countries, the people round our projects, could say: hang on, where did that money go? How was it actually spent? What was built with it? How is the country a better place?

I know taxes-paid is highly controversial amongst some of you here, but let me assure you, transparency is a better way – the best way – of ensuring that the people around mining projects do get value and that you drive out corruption and drive out bribery. Let me just assure you how important that physically is. The UK is one of the largest aid providers to developing countries. The UK, amongst others, want to make sure that that money actually goes through to where it was intended. Fighting corruption and fighting bribery is a very important issue. That's why I'm co-chair of the B20 Anti-Corruption Task Force, because it is an important issue. It is an area where you're going to have values. It is important when you stand up and you say: this is not going to happen. Rio Tinto does not pay any bribes. Nothing, not even facilitation. We don't even make political donations, which at times is quite convenient. 'Oh, our policy won't allow me to do that'.

But it's important you've got those values and it's important that people understand it. A company is built on the integrity of the business. Integrity starts at the top. Justin, Archbishop of Canterbury, asked me recently – it was in the context of banks, I hope no one here is from a bank – he said: Sam, Rio is a company that is built on its values and ethics. How do you get there? I said: well, Archbishop, it actually started 140 years ago, when we were established. It works through very clear guidelines. We have the way we work, which actually spells out what are the things we do, what are the things we don't. How do we operate with integrity? How do we operate with trust? How do we ensure that people don't head off into the blue yonder? That's how you do it.

But most importantly, it comes from the top of the organization. It comes from the board and it comes from the chief executive. If you are not living those values, then you can't expect your 62,000 people around the world to follow it.

Evan Davis

I think there's a great deal of truth in that. Okay, we've had our sort of smattering of topics – all of them beginning with 'c', from corruption to China to commodity price cycle to consolidation. You may have topics that don't begin with ‘c’ that you'd like to talk about, so we'll take some questions.