
BHP Billiton: Hole in the ground

Sitting in an office in Vienna, mainly focused on industrial stocks from anywhere in the world but Australia, it's easy for me to forget just how stunning the resources reversal has been. The share price chart of any major commodities producer is a stark reminder.

The BHP Billiton share price, for example, is down 70% from the peak. And that's in Australian dollars, the share price fall would have been more acute if not for the massive fall in the Australian dollar over the past few years.

BHP is far from an exception. Look at any of the majors – Rio Tinto, Vale, Anglo American, Glencore – they're all down 70% plus from their peaks (2007/08 or 2011 mostly). Most of them are trading at roughly 2004 share prices. It's like China never happened.

But China did happen.

BHP, for example, has taken net borrowings from around US\$5bn in 2004 to US\$25bn today. That's US\$20bn all gone into new holes in the ground.

Its balance sheet shows that over that 12 year period, it has retained about US\$50bn in earnings (ie profits not paid out as dividends). That's another AUD\$71bn gone into holes in the ground. Given the anaemic capital gains since 2004/05, that US\$50bn of retained earnings might as well have been piled up and set on fire, that's how much value it's added.

Production volumes are up massively. Revenues have doubled, despite the massive pullback since 2011. By almost any measure, BHP is a bigger company than it was in 2004.

China clearly happened.

But in terms of shareholder wealth, the one that matters, it's all been for nought, or close enough. Chinese demand didn't create untold wealth (in the long run), but rather induced investment by the majors to the point of malinvestment. It's a cycle that has repeated endlessly over the eons.

That's why the major task for successful investors is to make the distinction between high quality businesses—those with pricing power and a moat—from run of the mill commodity price-takers. In the short term, they can be easy to confuse. But long term, only the high quality businesses can turn an economic tailwind into outstanding shareholder returns.

Australian investors forgot which type of business BHP was, and bid it up to unreasonable prices. They won't forget that lesson soon, but they will again one day. For future reference, there's a very obvious hint about the quality of the business in the name of the sector. They don't call them *commodities* for nothing.