Storm clouds are lifted

It's been a roller coaster ride for Rio Tinto and its shareholders. But with the recapitalisation programme completed, more stable times lie ahead, reports *Review* editor Hugh Leggatt.

As for a homeowner caught fixing the roof when the hurricane blew in, the timing of the global financial crisis was an ill wind for newly debt laden Rio Tinto. The foundations and walls were always strong, but the house was dangerously exposed.

After weighing a number of creative options to make urgent repairs, a new shelter has now been well and truly nailed down with a US$15.2 billion capital raising. The rights issues in the UK and Australia in June/July, with a strong take up by shareholders, has dramatically recapitalised the Group, removing concerns about debt and stabilising the finances.

Said Tom Albanese, chief executive: "The execution of the rights issues has been a great success, especially given their scale and complexity. They put us on a much stronger footing going forward and enhance our flexibility in these uncertain times."

The rights issues – which gave existing shareholders the right to buy further shares in proportion to their existing shareholdings at a deep discount to the market price – will substantially reduce net debt by US$14.8 billion, well ahead of the US$10 billion reduction target for 2009.

Rio Tinto is now back in steady state as a long term value proposition, and a line has been drawn under a particularly difficult period for the Group. "The rights issues have handed us back the keys to our future," said finance director Guy Elliott.

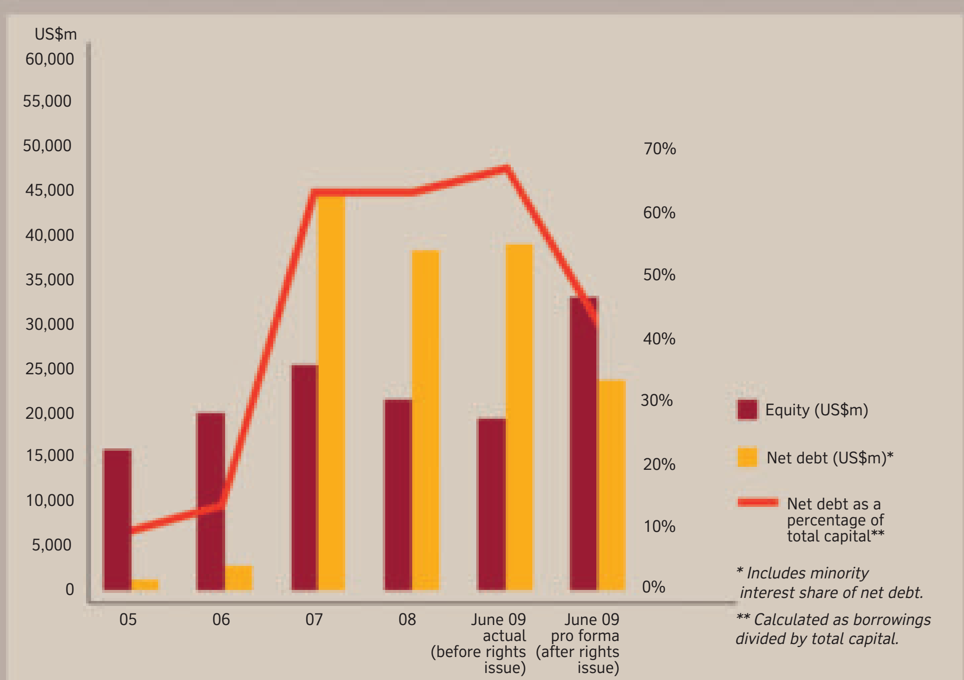
The rights issues were the largest undertaken by an industrial company and the first by a dual listed company.

Described by Guy Elliott as an extraordinary gesture of confidence, shareholders took up 97 per cent of rights offered in Rio Tinto plc and 95 per cent of those offered in Rio Tinto Limited. All members of the board took up their permitted entitlement in full. Chinalco, Rio Tinto's biggest shareholder, also took up its full entitlement of shares, spending US$1.4 billion to ensure its nine per cent stake in Rio Tinto is not diluted.

The rights issues are expected to reduce the debt:equity ratio ("gearing") of the balance sheet to a more comfortable 42 per cent from 67 per cent. And this is before US$5.8 billion proceeds expected to be received in due course from the proposed iron ore joint venture with BHP Billiton (see page seven).

"Even with this substantial decrease in our net debt position, we are not complacent," says Guy. "We are continuing with our operating and

Net debt and equity



As the rights issues were completed after 30 June, resulting net debt and equity are also shown pro forma as if applicable on 30 June.

capital cost reduction initiatives and our asset divestment programme in order to improve our financial position even further. While trading conditions are still difficult, we now have a lot more leeway to focus on our strengths and make the best of our platform for growth.

"While lifting the debt burden means opening up options to grow, the cumulative effect of our actions and other initiatives under way will also assist in putting us on the path towards restoring a long term single A credit rating."

Bearing this out, in July, rating agency Standard & Poor's upgraded Rio Tinto's credit rating a notch and described the Group's outlook as "stable". Credit analyst Alex Herbert said the upgrade reflects the positive impact the proceeds of the rights issues will have on Rio Tinto's financial risk profile.

As a result of the rights issues it is likely that capital expenditure in 2009 will be US$4.7 billion. However for 2010, capital expenditure is expected to be reduced to near sustaining capex levels. "We are continuing to develop our capability to grow when markets rebound but at the moment we are not spending a lot," Guy said.

The welcome refreshment of the balance sheet closes a chapter of high drama at Rio Tinto that lasted nearly two years. With its debt exposure behind it, the Group is now able to relaunch its growth and value story as a world leading metal and minerals producer with some of the best assets in the sector, especially in iron ore, copper and aluminium.

And it was the attraction of aluminium, namely Alcan's unique assets – low cost smelters, abundant low carbon hydroelectric power and technology leadership – that began it all.

Rio Tinto had its eyes on Alcan for many years. In 2007, Alcoa announced a hostile bid for Alcan.

650,727,575

The total number of valid acceptances received in respect of the new shares.

US$15.2 billion

The total amount raised by the rights issues

97%

The proportion of new Rio Tinto shares on offer taken up in the UK

95%

The proportion of new Rio Tinto shares on offer taken up in Australia

This triggered the opportunity for Rio Tinto to announce a recommended takeover offer. It was pitched at US$38.1 billion in cash, funded by debt. The transaction was approved with 97 per cent of Rio Tinto shareholders in favour, and Alcan joined the Group effective October 2007.

The plan was to pay down the debt rapidly by raising US$10 billion through the divestment of non core assets, principally Alcan's downstream Packaging and Engineered Products assets, and also several Rio Tinto businesses that no longer matched the scale of the enlarged Group.

In the 2007 economic circumstances of strong metal prices and buoyant demand that generated cash flows of more than US$1 billion a month, this seemed to be a prudent way forward, especially taking into account the future cost saving synergies and economic benefits of the new acquisition.

But in October 2008, exactly a year after closing the Alcan transaction, the global financial crisis suddenly took hold and economic conditions nosedived.

One week that October, the horizon off Rio Tinto's port of Dampier in Western Australia was crowded with ships waiting to load iron ore for Asia, especially China. A few weeks later, customers were emailing "Don't send us anything more until it is clear what is going on".

The long boom was over. Rio Tinto acted swiftly to reduce costs and conserve cash, and to align production with reduced market demand. But high debt levels meant the Group was exposed.

It had been hard to imagine launching a refinancing while under offer from BHP Billiton, though the Group did complete two successful bond issues in June 2008 for US$5 billion and in April 2009 for US$3.5 billion.

Nevertheless, BHP Billiton's

withdrawal in November 2008 of the preconditional takeover offer it had made in February, brought into stark relief the extent of Rio Tinto's debt. In December, Moody's and Standard & Poor's downgraded their credit ratings for Rio Tinto.

Behind the scenes Rio Tinto was working on a series of options. One of the measures would not only raise US$19.5 billion to relieve the debt burden – an amount of money the then frozen financial markets were unlikely to disgorge – but also position the Group as a strategic partner with its biggest shareholder, Chinalco.

In February 2009 a partnership with Chinalco was announced to deliver US$19.5 billion in cash to Rio Tinto. At the time it was a breakthrough that appeared to be ideal. But the terms became controversial, especially in Australia. As markets thawed over the next few months it became necessary to renegotiate with the Chinese, but no agreement could be reached.

On 5 June after widespread shareholder consultation, the rights issues and the break with Chinalco were announced, though Rio Tinto emphasised it remains interested in future collaboration with the Chinese resources giant.

Guy Elliott says that the US$15.2 billion rights issues were an elegant solution. "Since the February announcement of the Chinalco transaction, financial markets showed a significant improvement. The consequences were that the terms of the Chinalco transaction became markedly less valuable and Rio Tinto's ability to raise equity on attractive terms improved considerably.

"In parallel we were approached by BHP Billiton about the possibility of establishing a highly attractive Western Australian iron ore production joint venture that would deliver substantial value to shareholders." Guy went on: "So we have been able to raise quite sufficient money to pay the 2009 and 2010 debt payments through the rights issues. We have dealt with those two years at a stroke.

"Furthermore, the key thing is that the rights issues comprehensively change our balance sheet. They give us options for the future. And they put beyond any doubt whatever the strength of the company to pursue growth in a measured manner going forward."

"With funding uncertainty finally removed, Rio Tinto now has access to a more robust balance sheet."

Deutsche Bank, 5 June 2009.

"... by raising such a large amount of capital, Rio Tinto now has flexibility to restructure its portfolio and invest in the sector."

Merrill Lynch, 6 June 2009.

"Rio Tinto has tried investors' patience but it is now on course."

Daily Telegraph, London, 9 June 2009.

The recapitalisation also gives Rio Tinto more muscle in negotiating prices for asset disposals which are going ahead despite the urgency for new cash having fallen away. "We're going to progress with these asset disposals in a manner which is efficient. And we'll be pushing ahead with them. But we can be a little bit tougher on those who are buying businesses from us."

During 2008 and 2009 so far, the divestment of non core assets for US$6.7 billion has been announced, including in July this year, the sale of the Alcan Packaging Food Americas division for US$1.2 billion. In August a binding offer was made of US$2.025 billion for the majority of the rest of the Alcan Packaging businesses.

Earlier this year the Group sold its interest in the Ningxia aluminium smelter in China for US$125 million, its potash assets and Brazilian iron ore operations for US$1.6 billion and its Jacobs Ranch coal mine in the US for US$761 million. The divestment programme continues for other assets identified for sale, including the remainder of Alcan Packaging and Alcan Engineered Products.

Money from the rights issues is being used in the first instance to repay debt. The nearest important maturities will now be in 2012, which gives the Group plenty of scope to determine the best way in which to handle the 2012 obligation.

The successful June capital raising of US$15.2 billion means the bold move on Alcan in 2007 that left Rio Tinto exposed in the downturn can now be vindicated. And further value is expected to be gained from the rationalisation of Australian iron ore operations expected to start in 2010. Safely and securely, the roof's back on.

Find out more at www.riotinto.com