WILSONS

The Bigger Picture Behind BHP's Unification Plan

Our weekly view on Australian equities.

19 January 2022

BHP's 'Clean-Up'

This week BHP will ask shareholders to vote on ending the company's Dual Listed Company (DLC) structure that has been in place following the 2001 merger of BHP and Billiton. As Australian investors we are supportive of the move, despite the initial response that saw the historic price premium of the Australian BHP shares (Ltd) collapse relative to BHP London (Plc).

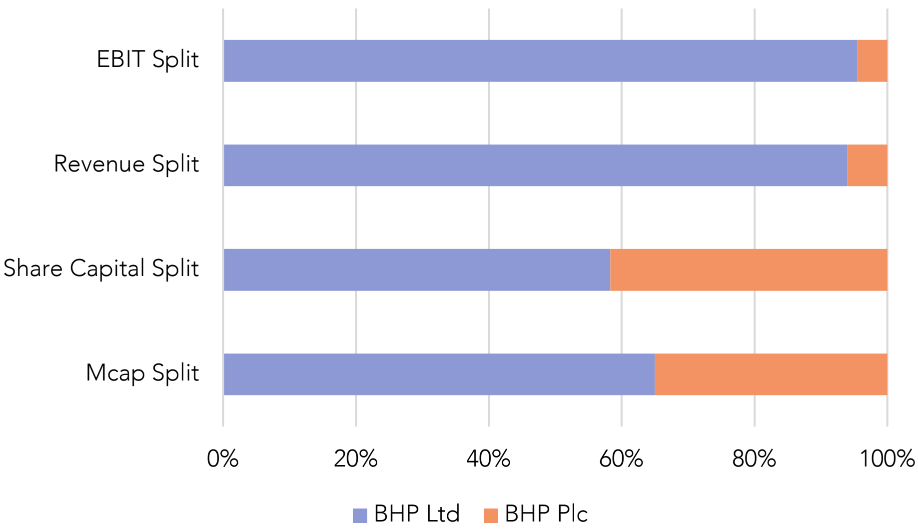
We see the benefits of collapsing the outdated structure currently outweighing the short-term costs. Unification is part of the broader portfolio 'clean-up' program that BHP is undertaking. This will leave BHP in a stronger position, cleaning up businesses and processes that have weighed down on the diversified miner suppressing returns.

Reshaping to Become More Future-Focused

Collapsing the DLC structure should be seen in conjunction with the exit from legacy commodities like coal and petroleum (exited US onshore in 2018 and BHP/Woodside Petroleum (WPL) deal currently pending). The group's capital allocation and return on capital should improve. Areas of commodity growth like potash and base metals like copper and nickel can now take on more meaningful positions within BHP.

From BHP's perspective, removing ESG sensitive commodities from the portfolio like coal and oil avoids the valuation discounts global investors are increasingly applying to legacy-facing commodity businesses.

Exhibit 1: Plc earnings represent <5% of BHP, yet its share capital is 48%



Source: Refinitiv, Wilsons. Mcap split at time of unification announcement August 2021

A single primary listing on the ASX will also allow greater M&A flexibility and the ability to pass through franking credits more efficiently. With over $US16bn in franking credits (>$US3.00 per share), we would not be surprised to see additional capital management by BHP over 2022. The BHP/WPL transaction, separate to unification and due 1 July 2022, effectively unlocks $US6-7bn franking credits attached to BHP's Australian petroleum assets.

Investment Implications

Should BHP shareholders approve the unification plans, BHP's index weight within the S&P/ASX 200 will rise from 6.5% to 10.7%. BHP will reclaim its position as the largest company by market capitalisation on the ASX.

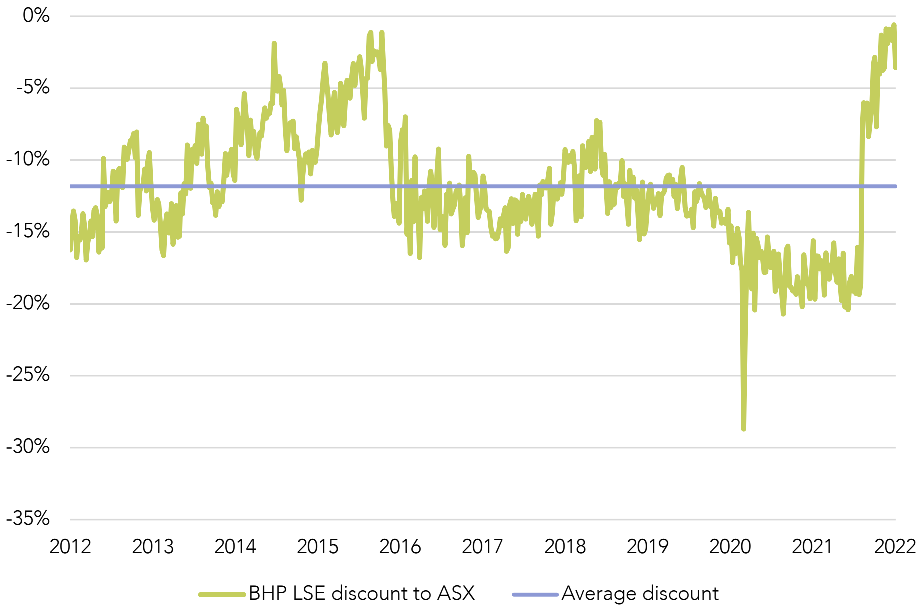
We have lifted BHP from 8% to 10% in the Wilsons Australian Equity Focus List.

Unification 101

Shareholders (notably Elliot Investment Management in 2017) have been pressuring BHP management to collapse the outdated corporate structure for almost a decade, arguing that the structure has outlived its intended purpose. The DLC structure followed the merger of BHP and Billiton that allowed BHP's mostly Australian shareholders, and Billiton's largely UK shareholders, to retain both economic interest and local listing of each company as well as certain tax advantages.

The structure has become increasingly less beneficial for the company, primarily as the old Billiton assets are now a much smaller component of earnings within the group. This has resulted in price distortion between Ltd and Plc share prices, which undermines a key objective of the DLC structure of achieving equivalent economic returns.

Exhibit 2: BHP Plc share price has historically traded at a 12% discount to BHP Ltd share price

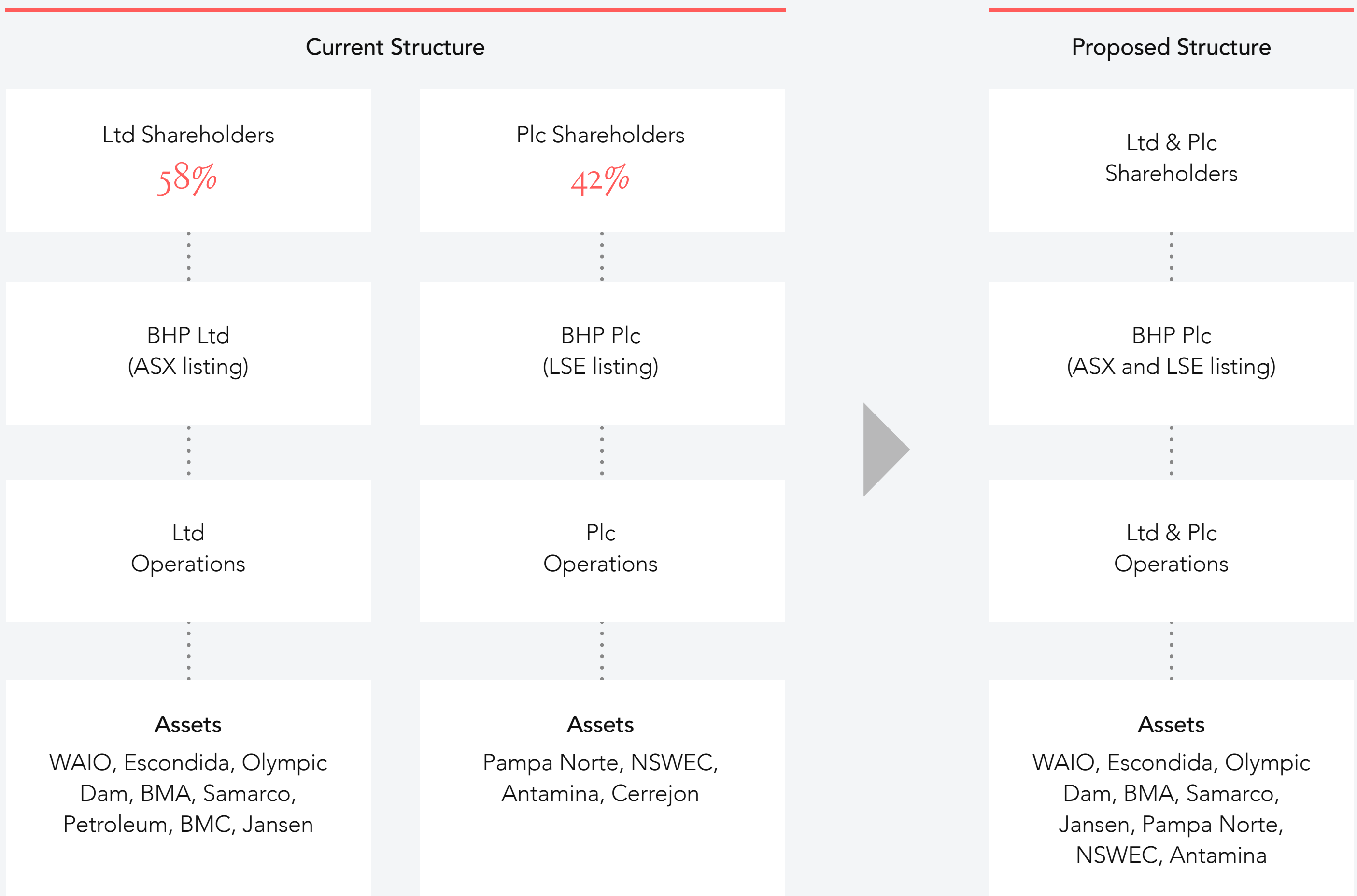


Source: Refinitiv, Wilsons

In our view, the complexity of the DLC structure adds an impediment for BHP management to consider M&A using BHP script (something BHP as DLC has refrained from). The treatment of franking credits between Ltd and Plc shareholders is also a matter of debate when it comes to capital management decisions. Simplification of corporate overhead and structure provides both cost benefits and should assist in organisational decision-making.

It is worth noting post DLC unification in 2005, Royal Dutch Shell (RDSa.AS) went on to buy BG partially using scrip, something it had refrained from doing in the 10 years prior to DLC.

Exhibit 3: BHP corporate structure pre and post-DLC unification



Source: Refinitiv, Wilsons

Key Benefits

We see a number of potential benefits from collapsing the DLC structure:

- **A simpler, more focused company** – Removing the DLC structure should lower corporate costs (not quantified by BHP). A larger advantage pertains to greater strategic efficiencies which arise from having a single primary listing. The corporate focus of the management team can be sharpened without having to consider the impacts on two groups of shareholders.
- **Increase M&A flexibility** – Including the potential use of script in M&A.
- **Potential for higher earnings multiple** – BHP Ltd has typically traded a 1.5-2.0x PE premium to BHP Plc. In our view, the premium is explained by a) an Australian premium for resources companies and b) franking credits carry greater value.
- **Greater access to franking credits** – BHP will remain an Australian tax resident company. More importantly, all shareholders will be able to benefit from franking credits. Off-market buybacks are likely to continue to present as an attractive form of capital management.

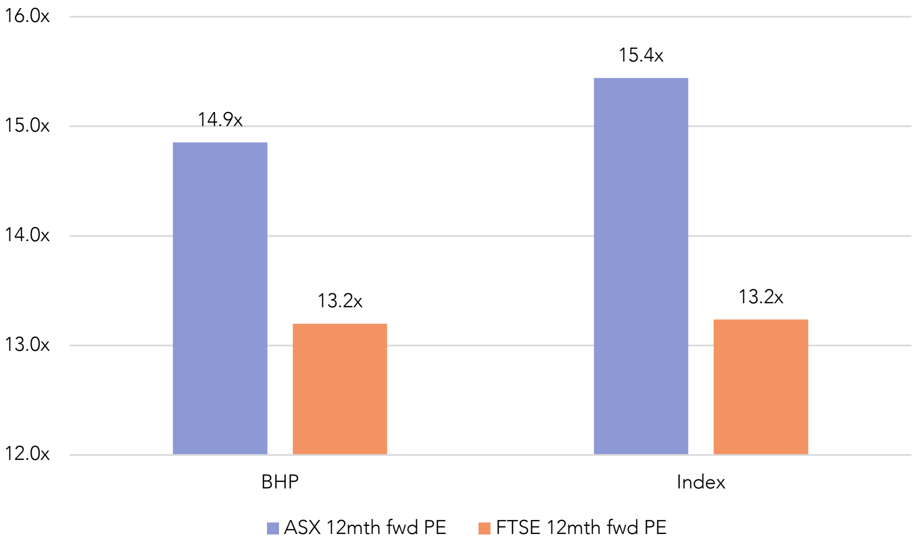
In addition to the DLC benefits, BHP is likely to continue to simplify the group's asset base – divesting coal, petroleum assets, whilst increasing investment into areas of expected commodity growth like potash, which should result in improved investor appeal.

The removal of coal and petroleum assets avoids the valuation discount currently applied to these assets, given perceived ESG issues (coal and oil assets) being just one benefit.

Future facing metals like copper and nickel are likely to receive a greater focus (and capital) from BHP to address production decline in existing operations and expand production to meet demand.

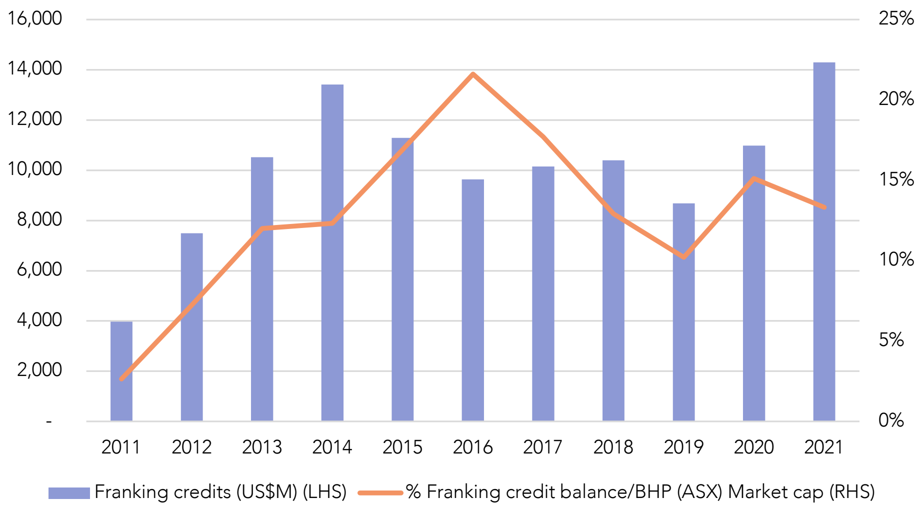
Currently, BHP's portfolio, ex all planned divestments, shows zero production growth over the next decade (an outcome achieved between 2016-2021) in copper equivalent terms, suggesting that further capital needs to be deployed to expand output.

Exhibit 4: BHP Ltd has typically commanded a higher earnings multiple vs BHP Plc since 2010



Source: Refinitiv, Wilsons. Average observed PE between 2010-2021

Exhibit 5: Franking credits have continued to build on BHP's balance sheet



Source: Refinitiv, Wilsons

Key Disadvantages

- **Financial costs** -The key financial cost of unification is a one-off charge of US$350-450m. This is down from earlier estimates of >$US1bn, primarily as the number of assets impacted is now much smaller.
- **Exchange Ratio** - This is the key disadvantage and is only felt by Ltd shareholders. Plc shares are being transferred on a 1:1 ratio, despite Plc shares being ~15% cheaper at the time of the unification announcement. This effectively results in a one-off, permanent transfer of value from Ltd to Plc shareholders. Whilst a more equitable exchange ratio could have better reflected the transfer of value, it was always going to be challenging for the BHP Board to find the right balance. In our view, it provides further rationale to remove the DLC structure. This is better to happen at a 15% discount vs a 30% discount which happened in early 2020.
- **Reliant on Ltd buyers being greater than Plc sellers** - With no financial adjustments or payments to either group of shareholders, the share price will remain the key measure of success. From a flow perspective, the sellers of BHP Plc stock need to be outweighed by buyers in BHP Ltd stock, resulting in a higher share price of BHP Ltd for the transaction to be considered a success in the short term.

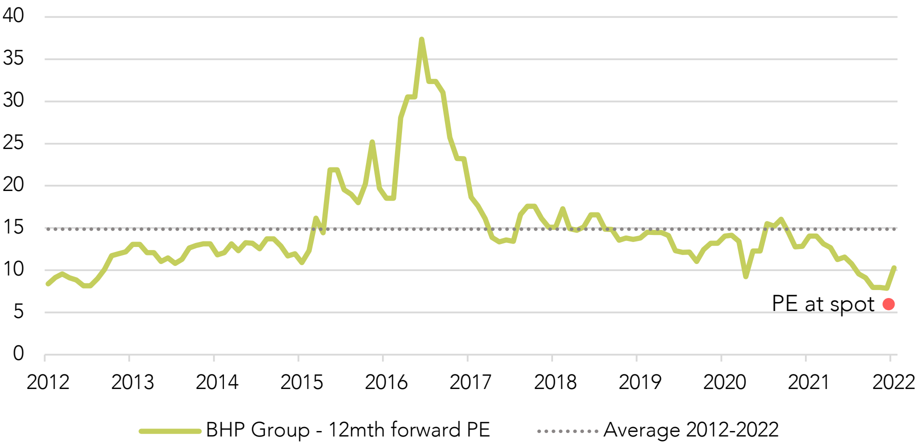
Market Implications

If approved, BHP's weight within the S&P/ASX 200 will increase from 6.7% to 10.7%, making BHP the largest stock by market capitalisation on the ASX. The adjustment will occur on 28 January 2022, pending shareholder approval on 20 January 2022. Just how orderly the exit of investors from Plc into Ltd remains to be seen. Passive investors will need to lift weightings to Ltd given the lift in index weight. As of 4Q21, passive investors controlled 15% of Plc vs 20% of Ltd.

With such a significant increase in weighting, active investors will also need to increase their weighting if they remain favourably positioned towards BHP. We think the near-term environment continues to look favourable for BHP, with buoyant commodity prices (spot commodity prices imply ~100% earnings uplift for FY22/23) and signs that China is looking to stimulate their economy. Resources are likely to continue to offer portfolios a degree of protection from higher inflation and rising interest rates.

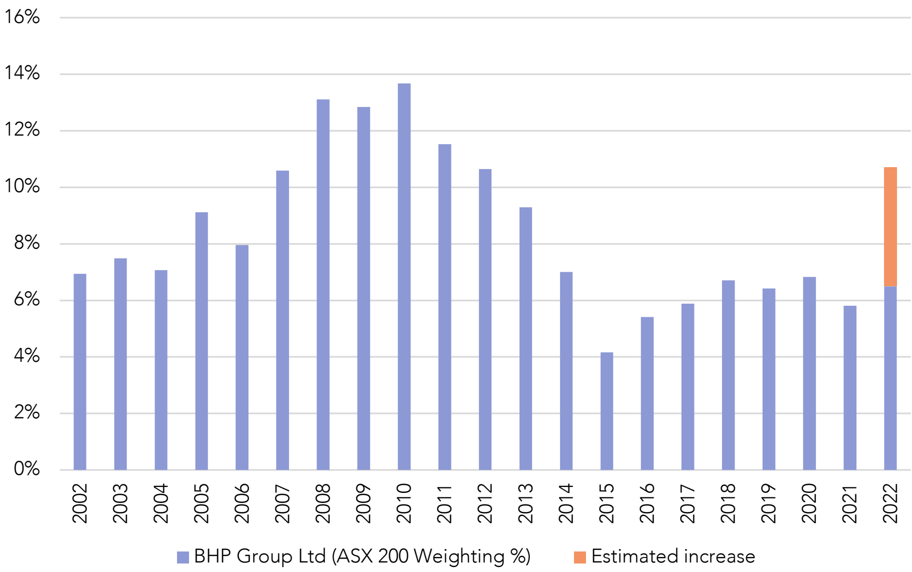
Further BHP simplification - namely the Petroleum divestment with WPL mid-year, potentially opening the doors for an accelerated return of franking credits ahead of the market's current view - could also lift the share price.

Exhibit 6: BHP's PER at spot commodity prices almost halves to ~5x



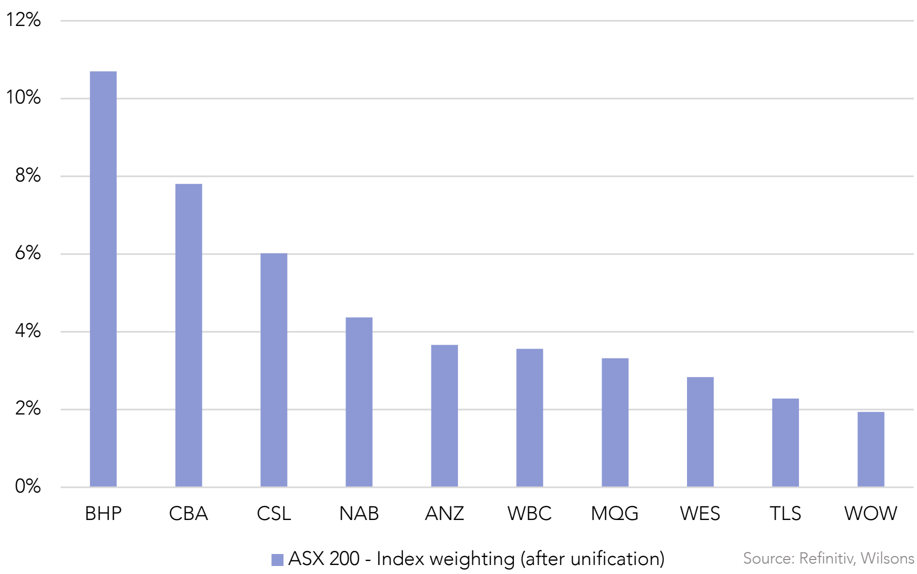
Source: Refinitiv, Wilsons

Exhibit 7: BHP's index weight will be lifted to >10%, it has been as high as 14% during the GFC



Source: Refinitiv, Wilsons

Exhibit 8: ASX 200 top 10 ranked by weighting post-BHP unification



Source: Refinitiv, Wilsons

Focus List Changes

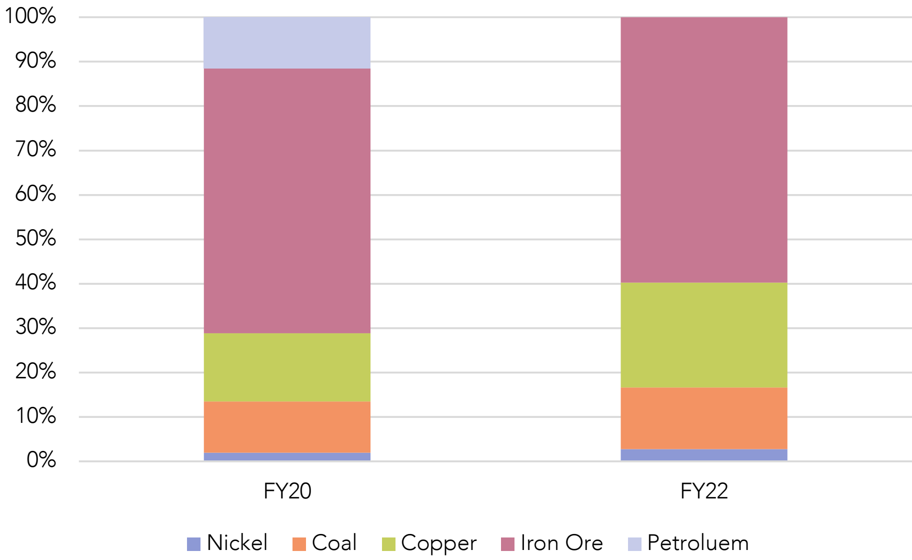
We have added +2% to BHP (now 10%). EML Payments (EML) reduced by -2% (now 2%).

Stock-specific factors for BHP look favourable – upside commodity risk, ongoing company simplification, the potential for capital management. Spot prices imply >100% upside to consensus numbers in FY22E/23E, implying at free-cash-yield for >12% in both years and dividend yield of ~10%. The backdrop of higher inflation and central bank tightening in 2022 should also support a higher weighting to the materials sector. The resources sector has performed only in line with the broader market since 2017/18, suggesting little of the global reflation/rising interest rate environment is priced into the sector at present. The recent outperformance of resources (since 4Q21) should put into perspective of last reflation cycle where resources outperformed for well over five years (2004-2011)

With the prospects for ongoing value/growth rotation in 1H22, we are reducing our exposure to the technology sector via the reduction in EML.

While we continue to see EML as offering value from oversold levels following the Irish regulatory issue in 2021, the ongoing rotation in markets is likely to limit both stock and sector upside in the near-term. We see better near-term relative performance in BHP.

Exhibit 9: BHP commodity exposure pre and post-the simplification program



Source: Refinitiv, Wilsons

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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