BHP makes record profit but the markets are far from satisfied

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Last month, BHP, one of Australia's largest companies, announced the highest net profit in its 115-year history. The $A1.63 billion profit ($2.03 billion before abnormal items were deducted) was also a record $3.9 billion turnaround from last year when the giant minerals and steel corporation recorded a net loss of $2.3 billion—the largest ever for an Australian firm.

Yet despite the record return, the response of investors was far from favorable. Immediately after the announcement the value of BHP shares, rather than rising, dropped by 2.7 percent. The reaction of the markets is certain to trigger a new round of cost cutting and job losses, particularly in the company's steel division.

The *Australian Financial Review* reported that fund managers were disappointed that BHP did not present a program of global acquisitions as part of their profit report. “Unless BHP launches into a major new commodity, there is likely to be less potential earnings growth,” the newspaper declared.

A breakdown of the company's historic profit reversal sheds more light on why investors are “disappointed”. The single most significant factor contributing to the record profit was the near doubling of the price of oil, which reached $39.46 per barrel, up from $21.22 the previous year. BHP's oil operations generated more than half of the record profit.

In addition, higher commodity prices, especially for LNG and LPG liquid gas and copper, increased BHP's profit by $620 million. Even with lower prices for coal and iron, the profit increases from commodity price fluctuations still stood at $380 million.

That a substantial part of the profit increase is the result of global commodity price fluctuations is clearly worrying many investors who realise that it is an uncertain and therefore unsustainable base for the long-term viability of the company. BHP management has tried to counter the criticisms by stressing the gains made from cost-cutting and asset sales.

It is certainly true that cost cutting across the company's operations and the dumping of non-performing assets is responsible for a major part of its profits. When BHP appointed Paul Anderson as CEO over 18 months ago, it confronted substantial losses as a result of its attempts to globalise its operations—it had lost a massive $7 billion over five years due to failed ventures and the over-valued purchase of Magma Copper in the US.

When Anderson took over the reins, the markets quickly let it be known that a wide-ranging restructuring program was expected. BHP share values dropped to $10.86 within the first two weeks of the appointment. No sooner had the cost cutting measures begun, including the sell-off of profit losing steel assets, than the share price rocketed to $21.50 in January, before settling at $16 in March. The share price is now hovering around the $19 mark.

The company-wide cut backs contributed an after tax return of $424 million to the record profit, scaled down to $330 million after depreciation and other variables related to superannuation expenses. The figure equated to 2.6 percent reduction in operating cost.

At the centre of the restructuring program implemented over the past 12 months was the disposal of non-performing steel assets, including the closure of BHP's Newcastle steel plant at the cost of 3,000 jobs. In total, $3.5 billion in steel assets were earmarked for disposal worldwide affecting at least 9,000 jobs. Sale of the company's Magma Copper interests added a further $325 million to the bottom line. The restructuring also included the write-off of other loss-making areas—more than $700 million for BHP's iron operations in Western

Australia and over $200 million lost on the sale of its US west coast steel assets.

At the centre of BHP's global restructuring is its move out of the “old economy” steel business into mineral and petroleum production. A breakdown of the profit figures reveals why. BHP's Minerals Division posted a $1.22 billion profit and its Petroleum Division returned $1.16 billion. Despite its heavily reduced asset base, BHP's Steel Division only returned $410 million and even that was a 53 percent increase from last year. Compared to steel, earnings from petroleum were up 259 percent and minerals 80.5 percent.

It is not enough that the steel division is making profits. It has to match the rate of return of other divisions and other corporations, both in Australia and internationally. There is no doubt concern among investors that BHP has only set a target of a 12 percent yearly return on capital investment for the next five years, far below the internationally accepted benchmark of 15 percent.

In announcing the profit result, Anderson admitted that BHP would find it difficult to meet its cost-cutting target of a further two percent in the next financial year, despite its plans to axe a further 800 maintenance jobs at the Port Kembla steel plant. But such is the inexorable logic of the capitalist market that BHP management will now be under great pressure to find new areas to slash jobs and conditions.