

Mining Dealmakers

Why can't they just dig, make and sell?

By John Robertson

Reading time: 5-10 mins

Deal making among junior resources companies puts at risk potential returns for ordinary shareholders. A clearer focus on what builds value, including a strategy to pay dividends, could add more to prospective returns.

The penchant among resources companies to do deals seems never-ending. And, yet, the real test of their success is, put simply, whether they can dig a hole, make something and sell it profitably.

Activities which distract managers from this primary task pose risks for investors which need to be recognised in evaluating a company's investment potential.

Copperco, an emerging miner with operations in Queensland, recently announced that it intended to merge with Mineral Securities. Both are ASX listed companies with market capitalisations of \$270 million and \$130 million respectively. Mineral Securities is an investment house with minority positions in companies in several countries.

In announcing their intent to merge, the two companies referred to the creation of a global mining house and argued the benefits of commodity diversification and economies of scale.

Similar arguments have been presented to investors recently by Sundance Resources and Gindalbie Metals, Bolnisi Gold and Coeur d'Alene Mines and, of course, among the giants, BHP-Billiton in its quest for Rio Tinto. Perilya and CBH Resources have also confirmed ongoing talks "regarding a possible corporate transaction".

It is especially sad when some of the budding firms with potential for excellent shareholder returns, based on real growth, fall victim to the myths promoted by impatient dealmakers.

A quick fix

Too many men in a hurry can garner too much influence. In the cases of both the Sundance/Gindalbie and Copperco/Mineral Securities transactions, there were common directors instigating mergers. One has to ask, under these circumstances, how much of a transaction is motivated by purely commercial considerations and how much by personal deal making tendencies which are opportunistically pre-empting more appropriate longer term development plans.

Investors should be wary about putting money into those companies with directors straddling multiple boards and using those roles to exercise a disproportionate influence on business decisions.

Miners as investment strategists

Miners are not investment strategists. When they usurp that role they risk damaging investment returns.

Investors aim to manage portfolio risks in different ways based on their individual needs. If an investor thinks it appropriate to combine Queensland copper commodity exposure with African platinum exposure, for example, he can do that or decide not to, as his situation demands.

When company executives, whose skills are in exploration or metallurgy, override these investment strategy decisions they may unthinkingly impose additional risks on their investors who have already made their portfolio decisions.

Diversification fallacies

Sundance claimed diversification benefits in proposing its merger with Gindalbie. However, they are both potential iron ore producers selling to the same buyers and responding to the same macroeconomic conditions.

The only diversification benefit comes from the possibility that two projects under the one roof are less likely to fail than two projects under two roofs.

Diversification, in this instance, was only going to be beneficial if there was a substantial chance of one of the projects failing. And, yet, prior to the merger, neither set of executives conceded the possibility of either failing to proceed.

A focus on a single project does have risks, but a single project is far preferable to none at all. Multiple projects, on the other hand, test management in ways that a single project does not, clouding the diversification argument.

Among small companies, diversification is frequently a distraction. Trying to operate multiple mines, producing different commodities in geographically separate locations, has proven a difficult task. Sometimes, gold and coal, even within the familiar confines of Queensland, have proved too much of a stretch.

In practice, few companies have shown the required skills to manage diversification. So few have been successful that an investor should probably assume *a priori* that none will do the job. The opposite assumption recklessly disregards a lot of history.

Branding

One man's diversification is another man's confusion. Many executives do not realise that they can undermine their investment attractiveness by creating confusing messages about their company's identity and direction. Mining companies need to cultivate and sustain a brand. Unfortunately, few executives in this industry think of themselves as brand managers.

The importance of brand management is not confined to the small end of the market. There was a time when BHP was seen by global investors as a proxy for Australia. When funds were allocated to Australia, in many instances, BHP was the automatic entry point, especially among investors unfamiliar with the Australian equity market.



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In the 1990s, BHP decided to distance itself from the Australian economy and become a diversified mining house. In doing so, it removed the rationale among many of its shareholders for holding the stock. It took many years for BHP to rebrand itself and create a new role in portfolios. During the transition, investors sold BHP stock because the original reason for investing was no longer valid.

Global = Sell!

Any genuinely global resources company is based around a core high quality asset (i.e. long life and low cost). A collection of second rate assets, which people were reluctant to support individually, is no basis for a global company (or any company, for that matter) no matter how widely spread they might be.

Having the word “global” in a PowerPoint presentation, sitting alongside “diversified”, is a strong temptation that few companies seem able to withstand. BHP-Billiton is global, but there are very few that make the distance. BHP itself nearly failed to do so.

History says it takes at least 50 years of stepwise strategies and a strong resource base, managed by highly skilled people, to achieve this status. If a company even hints that it is going to be global in two or three years, we can justifiably respond by telling its executives to pull the other leg! Sell!

The need for patience

Many resource sector executives do not have a track record of delivering value for their investors, some because they have not spent enough time as head of a public company, others because they are just not sufficiently skilled. And, yet, they are often miffed that investors do not give them the benefit of the doubt.

Company executives need to continually remind themselves that they are using other people’s money. As they get one thing right they will be entrusted with more. Sure, it might take 10 years rather than two to establish a track record, but that is what investors require, especially when they have a spread of investments from which to choose.

Trying to short circuit this necessary process through deal making, no matter how imaginative, potentially forestalls the judgments investors must eventually make. Preventing them from coming to those judgments delays or ultimately erodes the capital raising potential of the company.

The myth of scale

Economies of scale are rarely possible in the mining industry. In contrast to manufacturing facilities, which can be expanded or relocated to more cost efficient places, mines happen where Mother Nature intended and on a scale that she allows.

Unless properties abut one another, economies of scale in this industry are limited to little more than savings on corporate office space. And, then, those economies might be eroded by having to service multiple locations in geographically dispersed centres.

The role of dividends

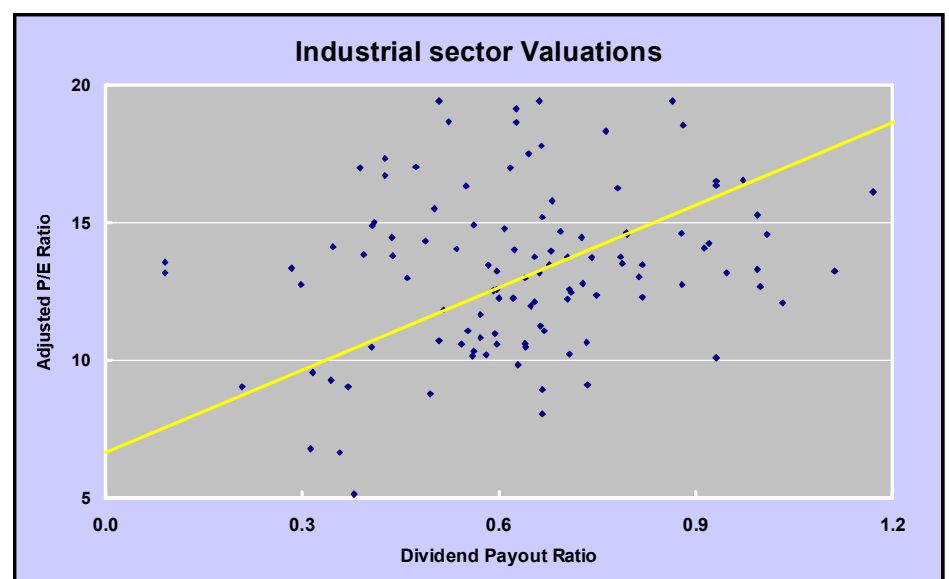
Meanwhile, for the widget maker and the miner alike, markets reward real financial achievement. One test of real financial achievement is the willingness to pay a dividend.

The industrial sector of the Australian market generally rewards those companies which offer the most significant dividends. The **first chart**, based on consensus company earnings and dividend payments for 2007/08-2008/09, illustrates the linkage.

The horizontal axis shows the dividend payout ratio for some 140 ASX listed industrial companies. The vertical axis is a measure of relative value.

The price people are prepared to pay for any company reflects a combination of factors, including the current absolute level of earnings and their anticipated growth rate. The vertical axis is a measure of stock P/Es based on 2006/07 earnings, adjusted for the anticipated earnings growth between 2006/07 and 2008/09. This is measured using consensus earnings data compiled by *thebigpicture* Economics.

There are other factors at work, but the empirical evidence seems to verify that, everything else being the same, investors pay more for companies committed to a higher dividend payout.





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Based on this way of looking at the data, raising the dividend payout from 30% of earnings to 60%, for example, improves market value, on average, by 29%. Any dealmaker needs to assess this possibility against any alternative strategic options which might prevent or limit a dividend.

Dividends are less frequently paid among mining companies. Few resources companies seem prepared to articulate a financial strategy which includes the payment of a dividend to accompany their operating strategy.

One recent example of a company courageously breaking the mould has been junior nickel mine developer Western Areas. It outlined a business development strategy in mid-February 2008 that explicitly admitted the goal of paying a dividend within a defined period of time as a way of delivering value for its shareholders.

The **second chart** shows market ratings for a selection of dividend paying resource stocks based on 2006/07 earnings outcomes. Again, despite the variance around the trend, there is a clear tendency for dividend paying companies to be more highly rated than those not paying or limiting their payouts.

In evaluating investment alternatives, potential investors need to assess the commitment of managers to dividend payments. Without any commitment, investors can legitimately question whether executives will maximise the potential value of the funds they have been given to manage.

Statistical analysis of the mining industry data suggests that raising a dividend payout from zero to 40% could double share prices, everything else being the same. Taking the payout to 70% could triple investment returns.

The market appears especially sensitive to dividend paying resources companies, perhaps reflecting their scarcity value.

This is a small sample covering companies with a variety of size characteristics and we should be careful about drawing precise numerical conclusions.

Nonetheless, as the chart emphasises, the potential returns from a well framed dividend policy might be much greater than from a corporate transaction with less clear-cut results for investors.

Covering all bases

Companies might be reluctant to pursue this option when they are preoccupied with their development plans, but the message here is that companies that ignore this important route to higher value are doing their shareholders a disservice.

Potential dealmakers need to explicitly admit this possibility into their decision making to give due consideration to the best interests and preferences of individual shareholders.

One of the fears of company managers is that they might not regain access to capital if they “give it away” through dividends.

That fear might be misplaced on at least two grounds:

1. many investors will provide ongoing support through dividend reinvestment schemes; and

2. executives might be able to cultivate a more committed shareholder base by demonstrating their attentiveness to the interests of their shareholders. In recognising the value shareholders place on higher dividends, they might gain greater access to capital at a lower cost, in the longer term, making for a more sustainable business outcome and one less reliant on risky deal making to boost value.

In short, markets reward success and recognise the value of managers who fulfil their investment needs.

John Robertson is proprietor of thebigpicture Economics and publisher of thebigpicture Review. He is also a member of the investment committee of the Emerging Resources Company Share Fund, a resource sector specialist fund managed by E.I.M. Capital Managers. The Emerging Resources Company Share Fund may hold stocks mentioned in this article or may buy or sell them in the future.

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