Mining and the real cost of capital

Properly compensating investors would force more financial discipline on companies

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The mining industry executive who recognises that equity capital comes at a cost deserving of compensation is rare today. Flicking through the December 1936 issue of a US newspaper recently, my eye was caught by one article. The US Smelting and Refining Company had reported earnings for the five months to May 1936 of US$2.71/share and paid a US$2/share dividend. That, according to the report, was after paying a US$1/share dividend in March.

The stark contrast with the modern mining company's approach to rewarding shareholders hit home. Today's model is predicated on getting rewards from share price movements, not the production of income from projects. Where there is income, the modern industry model usually includes a steely determination to keep as much of it as possible for redeployment in other projects.

Most companies in the sector are not producing so the question of dividend policies is generally premature and easily fobbed off by a reference to some future determination by directors. All listed companies, however, have raised capital. Yet few have explicit policies saying: "This is what we owe the people funding our business and the standard against which we will be judged."

The industry has largely eradicated talk of capital management strategy from its lexicon.

Companies are often at pains to define project returns but rarely talk about the returns an early stage equity investor might receive. Take, for example, a miner that listed in 2007 when it raised US$40 million. An investor could reasonably ask for a 20%/y return on the funds subscribed. Consequently, by the beginning of 2014 the holding should be worth around US$140 million if the cost of capital was to be covered.

Understandably, in a cyclical industry, returns are not going to be evenly spread but all that means is that the amount due to an investor at a later stage, allowing for the cycle, should be so much greater. Capital-conscious directors would be recognising that this is a minimum test of whether they are delivering value.

There are some commonly observed signs from the way directors present their companies that show how little they care about the need to target appropriate rewards for early stage equity investors.

A company presentation documenting anticipated sources of news flow as the source of higher share prices but offering nothing about targeted capital returns is one.

Another is when quoted internal rates of return are based only on the last capital contribution to a project and ignore earlier essential capital subscriptions that have sustained the company for years as the necessary preliminary work has been completed.

Companies also quote payback periods based on when the last capital is subscribed. One company recently claimed that a project had an 18-month payback, ignoring a succession of share placements since 2007 when the first capital for the project was raised. This was a clear sign that equity capital was being ignored in any assessment of returns.

The irony here is that investors incurring the greatest risk are given the least consideration.

The standard investment presentation makes no reference to how much capital has been subscribed so far. If no one is keeping this number close to the top of their thinking, calculating a rate of return has, by definition, been abandoned.

If the company places no value on equity, it is unlikely to make judgements about projects that ensure the cost of equity is covered adequately.

The absence of objectives in executive remuneration plans relating to returns on capital is another giveaway that compensating equity does not matter.

Companies sometimes have mission statements defining their goals. Few mission statements in the resources sector recognise that shareholders should be compensated for the capital they have committed or that projects should be assessed against their potential to deliver such a gain. Being a competitive investment rarely features as a goal. The mission statement is more likely to be about becoming a global mining enterprise than achieving a targeted return from building a mine based on a specific resource.

Companies that claim to align the interests of their executives with those of their shareholders through option schemes are displaying their disdain for the way shareholders get their returns. Handing out options over shares may be a legitimate and effective way of attracting staff. However, shareholders have had capital at risk. Executives without capital at risk claiming an alignment with shareholders while benefitting from a share price rise are demonstrating a failure to understand the costs of buying equity.

Capital raising was on the agenda at Mines and Money in London

Unexplained project delays can also show contempt for the cost of equity. The company that has raised US$100 million and delays a project for 12 months owes investors an additional US$15 million, say, if the cost of capital is 15%. If the capital had been debt funded, the obligation to service the cost of capital would be clear. In the extreme, capital could be withdrawn by the funder. At a minimum, the servicing charges would be capitalised. There is no such accounting for equity holders, even informally.

Companies that fail to frame their explanations for project delays within the context of the opportunity loss for shareholders are showing a failure to understand that equity capital has value.

Portraying returns as being unaffected by project delays is not only analytically suspect, but again says that equity holders do not count.

With a little luck, there will be a cyclical rise in commodity prices in 2014 and equity prices will swing higher, and equity capital will flow more freely. More realistically, a cyclical recovery might be several years away. Capital will remain scarce and expensive with superior returns in other market segments making investors reticent about supporting mining activities.

The successful companies will be those that can offer a break from a model which is failing investors. Signs that equity returns are being given a low priority will be given increasingly greater weight in markets where the value of equity is rising.

Capital will flow to those investments, including outside the sector, where recognition of the cost of capital is more readily forthcoming. This is not a speculative forecast. It is happening already. ▼

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