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Capital structure myth debunked

A 'tight capital structure' may be a red flag warning of danger rather than the frequently touted investment attribute advertised as a reason to buy.

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The idea that two otherwise identical companies can produce divergent investment returns simply through differing numbers of shares on issue depends on several misinterpretations of market and industry behaviour.

Let's say, for example, that ABC Zinc Limited has a market capitalisation of $20 million with 200 million shares on issue concentrated in the hands of a few investors. Its implied share price is $0.10. XYZ Zinc Limited, with exactly the same exploration, personnel and financial attributes, also has a market capitalisation of $20 million but with one billion shares widely dispersed among many thousands of investors. Its implied share price is $0.02. Then, both simultaneously report mineral discoveries prompting an immediate repricing of their securities. Let's also say that the objective post-discovery value of both is $50 million, implying identical share price gains of 250%.

Market mythology suggests that the actual return from ABC Zinc will be superior to the gain from holding an investment in XYZ Zinc. The premise behind the difference is that few investors in ABC Zinc will wish to sell, forcing newly eager buyers to push the share price higher, without regard to underlying value, until their demand for shares is satisfied. Meanwhile, fresh buying for XYZ Zinc will immediately attract selling from its more diverse shareholder base, placing a cap on the potential share price appreciation.

The first observation to make is that the diagnosed outcomes depend less on the number of shares than on the concentration of ownership and, related to that, the

propensity to sell. Put another way, the strength of commitment to the underlying investment proposition will dictate the outcome. If ABC Zinc and XYZ Zinc are both equally highly regarded, a 250% gain for both should eventuate.

The mechanics of market transactions might affect the speed of the respective share price rises. Prior to the discovery, ABC Zinc might have been quoted with a bid-offer spread of $0.10-0.11. The spread for XYZ Zinc might have been $0.02-0.03. The first post-discovery trade for ABC would imply a share price gain of 10%. The first trade for XYZ Zinc would produce a 50% change.

A propensity for companies to fail before they succeed may help explain the disparity between reality and expectations

Investors should expect XYZ to continue to display higher volatility due to its lower absolute share price with possibly greater short-term leverage - not less - to generalised changes in conditions.

A billion-plus shares on issue usually means prior corporate misadventures have necessitated capital replenishment, possibly at cyclically low prices. This could be an understandable warning sign but not a conclusive guide to future outcomes. Pilbara Minerals, widely respected today as a successful lithium miner with strong growth prospects based around a world-class resource, is a case in point.

Pilbara's present success hides many false starts. Since its listing in 2007, the company has looked for iron sands and gold in Indonesia, explored now discarded base metal properties in the Pilbara and investigated alternative opportunities in South America and Africa before pronouncing proudly in 2012 that it was committed to being a developer of world-class gold deposits, starting in Papua New Guinea. To that point and without yet stumbling upon anything of value, the number of issued shares had quadrupled.

Nothing has since been heard about the company's gold mining aspirations. A subsequently failed bid to start a tantalum mine, before the lithium craze threw it a lifeline, has also been nudged into the background. By the third quarter of 2015, with resource definition at its Pilgangoora lithium property still underway, the number of Pilbara Minerals shares outstanding had risen by over 1200% before a twelvefold rise in its share price.

If historical share issuance was a factor generally contributing to investment returns, one would expect to see the best performing stocks in the sector having fewer shares on issue than those companies with weaker investment outcomes.

Over the 12 months ended 31 December 2018, the 20 ASX mining stocks with the strongest share price appreciation had an average number of shares on issue of 1,311 million at the end of the year. Five of the 20 companies had more than two billion shares. The median number of shares issued by this group of companies was 778.9 million.

Over the same period, the 20 worst performing stocks in the sector had issued an average of 555.6 million shares. Only three companies in the group had more than one billion shares outstanding. The median issuance of the bottom ranked companies was 409.9 million.

A look at the stocks in the middle of the 2018 performance rankings reinforces the positive correlation between performance and shares outstanding. Among the 20 stocks sitting around the median return for the sector in 2018, the average number of shares on issue was 855.4 million. The median number of shares on issue of 696.8 million was also near the middle of the range between the top and bottom stock groupings.

If 2018 is any guide, strong performance equates with big share issuance. Weak performance comes with fewer shares. It would be hard to mount the 'tight capital structure' argument with this data.

Clearer investment market correlations - and examples so contrary to conventional thinking - would be hard to imagine.

A propensity for companies to fail before they succeed may help explain the disparity between reality and expectations.

Bright eyed and optimistic beginners with few shares on issue tend to disappoint in the first instance, pushing them into the lower end of the performance rankings. A second go, as with Pilbara Minerals, means another round of funding or more shares used to purchase a fresh collection of assets. With some luck, the new combination might work better but, as Pilbara Minerals showed, a third or fourth reincarnation may be needed before ultimate success dawns and a chance to sit atop the performance pecking order is created.

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