FROM THE CAPITAL

Companies do better after share consolidation

Evidence suggests strategy tends to work best for investors

John Robertson

Red Mountain Mining boss Jon Dugdale sparked a minor debate at a recent meeting of investors when he knocked back the idea of consolidating his 1.2 billion shares on issue because of the likely negative impact on the company's market value.

At least theoretically a consolidation or split of shares should have no discernible effect on the total market value of a company. In practice there is some evidence of a modestly positive share split effect. Among US retail investors particularly, a share split is often seen as an investor benefit. A splittable share is also taken as a sign of a successful company.

A share split would have to create fresh investor demand if it is to have an impact on market value beyond a small and short-lived announcement effect.A few extreme cases could buck the trend.

Berkshire Hathaway, whose A shares were trading at over US$199,000 each, comes to mind as genuinely expensive by the saving standards of retail investors. A stock split would open the market to more potential buyers.

Nonetheless, any tendency toward a higher market value should result in added selling at the margin as pre-existing holders of the stock take advantage of the improved liquidity to enter and exit more freely. Even in this extreme instance, the potential for a change in value is unclear.

Similarly, a consolidation should not have any material impact on overall market value aside from a possibly modest financial benefit where reduced share registry and investor communication costs are incurred.

Thoughts turn to consolidation, sometimes through embarrassment, after scrip-based asset purchases have failed to contribute value. While poor commercial judgment may be a source of share proliferation, the state of capital markets might also have an impact. Companies having to raise disproportionate quantities of capital at points of cyclical weakness simply through an accident in the timing of development sometimes feel pressured to mop up the excessive issuance.

Share consolidations are often initiated by new directors trying for a clean start. A new business model headed by fresh faces may

prefer to work with a restructured capital base. This is where unwarranted inferences about the negative impact of share consolidations can arise. If trading has been suspended while a company undergoes financial surgery, a radically lower market value may follow a consolidation.

A proper assessment of the consolidation effect requires a distinction to be drawn between symptom and disease. The contraction of share capital may simply be a symptom of an earlier regrettable history that caused a problematic blow-out in share capital.

Red Mountain Mining is seeking to develop gold properties in the Philippines. It has a 444,000oz resource with good exploration potential offering the chance of a low-cost open-pit operation. The company is close to finishing a definitive feasibility study and is relatively well funded. It now has 1.19 billion shares outstanding, an increase of 649 million since the beginning of 2014, with a market value of just A$3.56 million.

At one level, talk of share consolidation is an undesirable distraction. It is also hard to believe that the mere act of consolidation would cause the market value to fall further. But there are some strong opinions about the treatment of the capital base. Some investors see large share numbers as an insuperable barrier to an investment at any price. For them, a tight capital structure is an investment necessity.

Supporters of this position place little weight on the role of liquidity in supporting investor interest despite liquidity helping to narrow the bid-offer spread and contributing to improved market efficiency and lower transaction costs as trading is made easier.

Some of those most hostile to reducing the number of shares straddle the first camp but believe companies are consistently shedding value when they consolidate their share capital.

My database identified 41 share consolidation examples among ASX-listed resources companies over the year to July 2015. Over the period examined, the small resources share price index declined 37%. The median return among the universe of stocks comprising the sector was -33%. A strong downward bias in the returns among consolidating stocks, against this market background, would have been expected.

As it happens, 18 of the stocks in this group of 41 had share prices in the month immediately after their corporate actions at least as high as the adjusted share price immediately before the reduction in the number of shares. Another six of the 41 companies had share prices subsequent to the first month at least as high as the pre-consolidation value.

Slightly over half the stocks showed positive investment returns at some time subsequent to consolidation. Conversely, a number approaching half did show negative post-consolidation returns. The anti-consolidationists draw their conclusions about prospective performance from this latter group.

Somewhat surprisingly, a portfolio comprising the share consolidators would have offered superior investment returns than available from the market as a whole. That assessment does not take account of pre-consolidation losses, which might have prompted an original restructuring decision. The group of consolidation stocks experienced a median 50% loss over the entire year. Overall, they fared worse than the market but did better after consolidation than before.

The empirical evidence is mixed but does not support the blanket supposition that share consolidations themselves come with a negative market impact.

For Red Mountain Mining, the large number of shares in issue will remain a reminder of things not having gone to plan. The large number of shares will remain a source of ongoing potential embarrassment for directors. They will be constantly urged to tighten up the capital structure. The argument for action is not compelling, but nor is evidence of a likely loss in value. The pressure to remove the excess, whether well reasoned or not, will most likely prove too strong for directors to withstand. ▼

*John Robertson is a director of EIM Capital Managers, an Australia-based funds-management group. He has worked as a policy economist, business strategist and investment-market professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia