Mining Journal

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Where's the value: focus or diversity?

'Focus' and 'diversification' are bandied around as descriptions of corporate style so frequently they are largely bereft of any informational value.

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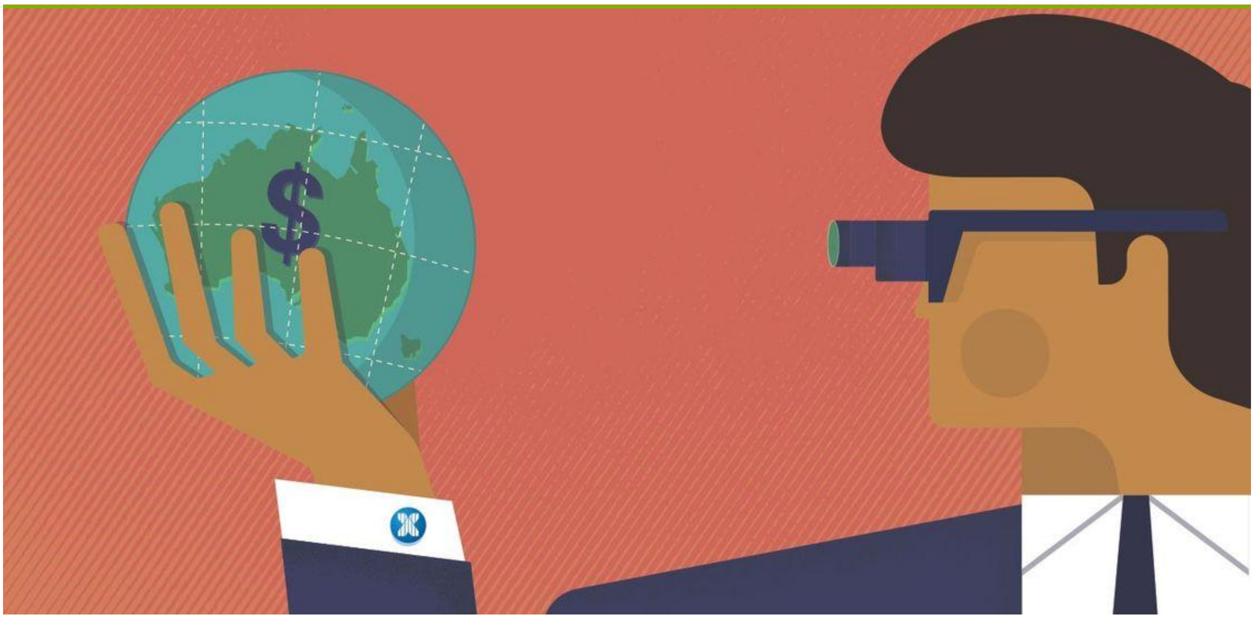

20 June 2019

Focus is such a highly regarded corporate attribute, its meaning is often stretched beyond any recognisable literal meaning to simultaneously accommodate multiple geographies, mineral styles and commodity exposures.

Pepinnini Lithium came to market with "a highly prospective exploration portfolio focused on the Musgrave Province". Now, it also has "a focus on lithium in Argentina and nickel-copper in Australia".

After a late 2017 board and management rejig, Jervois Mining directors committed to "a new focus on the growing battery metals market". Even while accumulating assets in East Africa and the US, "Jervois Mining is focused on moving its Nico Young cobalt-nickel project into production", according to a company statement in April.

As well as focus, Jervois Mining claims diversification. The company's acquisition of M2 Cobalt in January 2019 "enhances geographic and asset diversification", according to the directors. Its move to merge with eCobalt also gives it "enhanced geographic and asset diversification".

Broken Hill Prospecting spoke of "a third focus" and "an expanded focus", after acquisition in January 2018 of additional tenements in the Broken Hill area.

Nonplussed supporters can sometimes struggle to find consistency in the branding changes. Writers of a sponsored commentary for Broken Hill Prospecting described applications for the new exploration licences as "consistent with its strategy of diversifying the group's business" but felt compelled to immediately reassure investors that "while this involves multi-commodity exposure, the group remains focused".

Multiple projects or product offerings are not necessarily signs of strategic missteps. This is particularly the case outside the mining industry where companies may beneficially extend a difficult-to-reproduce core skill over diverse products or locations.

"**Preferring multiple projects, in the name of diversification, over a single project focus belies a common misinterpretation of the impact of risk on value creation**

Companies like Disney, Nestlé, Alphabet and Apple can deploy skills and resources across global boundaries and product categories to reinforce and add value to their core strengths, whether in brand management, efficient manufacturing processes or control over a technological ecosystem. Diversification both reflects and contributes to focus on already well established strategic advantages.

A mining company embarking on an asset transaction needs a similarly core attribute to persuasively argue that its asserted blend of focus and diversity can add value. Otherwise, its strategy is best described as bulking-up or empire building.

Far from its roots in finance theory, diversification for miners plays a multi-faceted role. It is often a smokescreen to hide indecision or justify otherwise inexplicable changes in strategic direction. It helps directors, keen to embrace the latest market fad, jettison past strategic commitments. It can blur insufficient progress on earlier points of focus.

Finance theory suggests superior risk/return portfolio attributes can be created through combinations of assets with differing risk/return characteristics.

For miners, a move from one asset to two or three may be insufficient to achieve any meaningful diversification. Diversification benefits, in the strict sense, will depend on the extent to which newly-acquired asset returns and risk profiles differ from one another.

After many years focussed on Tasmanian tin mine assets, Elementos added tin-related investments in Spain and Malaysia to turn itself into "a diversified tin platform…to develop exciting projects in multiple countries".

The Elementos approach is not diversification in any meaningful economic sense. The fortunes of all three existing properties heading toward production depend on the state of the global tin market. All rely on the same management skill base. The company does not admit any material differences in jurisdictional risk.

Preferring multiple projects, in the name of diversification, over a single project focus belies a common misinterpretation of the impact of risk on value creation.

Take a simple example in which a single project has a 30% chance of delivering a $100 million value increment, if implemented successfully, after an upfront capital commitment of $20 million. The risk adjusted value of the future benefit would be $30 million for a net gain of $10 million or 50%.

Let's say a company, such as Elementos, has lined up three such projects which are, for purposes of the example, identical. Having multiple assets would boost the potential value increment to $300 million but the chance of all being realised would fall to just 2.7%. The risk adjusted benefit would be a meagre $8.1 million for an outlay of $60 million.

Having three projects on the go does raise the chance of a single success. In this example, the chance of just one of the three projects being successfully completed would rise to 90% for a risk-adjusted $90 million return on an investment of $60 million and a net gain of $30 million.

Corporate size will have been enhanced but the strategy relies on the highly unlikely prospect of public market investors shrugging off two-out-of three project failures as simply the cost of doing business without any impact on market value.

In a third scenario, two of the three projects could be successfully completed. This would imply an outlay of $60 million for a 27% chance of recouping $200 million for an expected value of $54 million. Again, size is enhanced but value is destroyed.

Of course, specific real life circumstances will differ. A company's board might validly conclude that the chance of success from its current assets is only 10% or 20% rather than 30%, making abandonment of one project in favour of one with a higher chance of success a value creating strategy.

In any event, directors should hesitate before claiming benefits for shareholders from decisions to diversify a corporate asset base. Investors can already build their own portfolios of assets from public markets to reflect individual risk/return preferences without interfering executives pretending they know better.

Soundly-based decisions about diversification involving a thorough appraisal of risks may add value but, more likely, single-mindedly seeing a project to its conclusion is in the best interests of corporate value and investor portfolios.

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