Opinion

FROM THE CAPITAL

Returns versus status

Independence-Sirius merger appears less about returns than risk mitigation

John Robertson

Around 20 companies are testing Australia's most exciting mining investment proposition, namely, the idea that the Fraser Range is pregnant with multiple discoveries defining a new globally significant nickel province.

They are all seeking to replicate the experience of Sirius Resources, whose Nova-Bollinger discoveries catapulted the value of the company from under A$10 million (US$7.4 million) to as much as $1.5 billion.

Today, the 20 aspirants have exploration rights over some 27,000km^2 surrounding the maiden find. The 20 are together worth just $244 million.

But even that might exaggerate their market value. Sixty-five million dollars comes from Sheffield Resources, a large part of whose value is due to its Thunderbird mineral sands project. The median market value of the hopeful 20 is just $9.4 million, compared with a current market value of $1.2 billion for Sirius Resources.

The investment question prompted by this disparity is whether a bird in the hand (ie the Nova-Bollinger deposit) is a better option than one of the 20 in the bush. Independence Group must think so because it decided to pay more than $1.8 billion for Sirius when it could have spent one-tenth of that amount to effectively buy the entire Fraser Range region.

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The independent expert report prepared for the meeting of shareholders to approve the deal throws some light on one aspect of this choice. The Independence Group assets were valued at $871 million to $1.1 billion by the expert. Sirius was valued at $1.1 billion-$1.6 billion. On the day prior to the bid, the combined market value of the companies had been an extended $2.71 billion. The expert has declared the transaction fair and

Mapping a layered intrusion at Fraser Range

reasonable, as those terms are defined by Australia's corporate takeover laws, making a vote in favour a likely formality.

Since announcing their intention to merge on May 25, the two companies have lost a combined $958 million in market value, with significant declines in their respective share prices.

The small resources share-price index decline of 25% over the same period suggests shareholders of Independence Group have been unimpressed with the transaction.

Investors are currently paying $1.96 billion to get assets with an appraised value of $1.72 billion to $2.44 billion. That seems fair enough, but hardly a compelling reason to incur the risks of resource sector investing.

When the deal was announced, the benefits were identified as "a leading diversified Australian mining company with a strong portfolio of high-margin/long-life mining assets". There was no mention of the new entity being able to offer a superior rate of return. The independent-expert report adds meat to why such a claim could not be made: there was no objective evidence to support the argument.

Any investments benefits will rely on investors being prepared to pay a premium for the combined entity in the future over and above the value of the separate parts. There is a group of investors for whom size is more important than returns. These are the index hugging fund managers that eschew buying into a company until after its share price has already risen by enough to propel it into the S&P/ASX 100 or 200 indices. The directors of Independence and Sirius have some history on their side in using this as motivation for their strategic link.

Taking Sirius over also plugs a looming gap in the Independence portfolio of assets. Its three primary mining properties have an average life of just six years. That means, without an offset, the company's underlying value proposition would be on a downward trajectory within 24-36 months. Shoring up the market value through an acquisition is a common enough practice, but not the same as adding incremental value to the asset base. In this case, Independence is simply paying $1.2 billion, at current market values, to get assets with a similar value.

Investors generally, like Independence, have three ways of joining the Fraser Range fray. They can try picking a single winner. They can select a representative subset of stocks from among the 20 on offer to diffuse the risk. They can buy into the one company that has already made a find.

If the Fraser Range investment thesis has legs, companies such as Segue Resources and Boadicea Resources, among many others, should offer compelling investments. Boadicea is an $8.9 million company with one of the smallest landholdings, but some recent evidence that the sequence of rocks at Nova-Bollinger trends onto its nearby tenement.

Speaking to investors recently, the Segue Resources chief executive pitched a 4,000km^2 tenement package - the third largest among the companies engaged in the area - and 15 high priority drill targets as reasons for investing. The market value of Segue is currently $8.2 million.

Independence could have bought a dozen or so of the Fraser Range explorers yet to make an impact for as little as $120 million, at current prices. It could have spent another $60 million in fieldwork to give it a 15% chance, say, of adding $1,200 million in value. Rather than doing that, the Independence directors have decided that spending $180 million for a 15% chance of getting $1.2 billion is less attractive than spending $1 billion to get $1 billion.

Each person's unique risk profile will dictate how they come down on this choice. Some will respond positively to the status of an S&P/ASX 100 ranking. Others will be attracted to the more risky, but ultimately higher returns offered by companies with greater leverage to successful exploration.

In practice, most investors will think like Independence and prefer an investment with no return to an investment with a low chance of success even if the upside from the latter more than compensates for the risk. These are the investors to whom the Independence-Sirius alignment is ultimately pitched. ▼

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