

## Opinion

FROM THE CAPITAL

# Debunking capital structure myths

## How do investors really view shares on issue?

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The number of shares on issue tells an investor something about a company's past but little about its future investment returns. The value of a so-called tight capital structure has been questionable.

Having a small number of shares is an investment benefit, according to many junior miners out touting for investors. Executives will rarely explain the nature of the benefit they expect. The unstated article of faith is that a company with one billion shares, everything else being the same, is going to be an inferior investment to a company with, for the sake of argument, 200-300 million.

An example will illustrate the absence of logic behind this proposition. If, say, Company A makes a gold discovery. Based on its new market peers, it should have a market value of US\$35 million. Company A has the minimum number of shareholders required and just 100 million shares on issue giving it a share price of 35c.

Company B, on the other hand, is identical in all respects to Company A except that it has 500 million shares on issue giving it a share price of 7c. Let's say also that the market value of both companies before the discovery had been \$2 million or 2c/share and 4c/share, respectively.

The maths is straightforward enough. An investment in either company would have resulted in a 17.5 times gain in its value. There is nothing to choose from between the two. The number of shares is mathematically irrelevant to the investment return.

That leaves open the question of whether an investor might prefer Company A to Company B for a reason other than investment return. Since we have defined away any operational or financial differences, the shareholder structure is the only possible distinguishing feature.

The share register of Company A, let's say, is dominated by a handful of related investors who account for the majority of the shares on issue and who are unlikely to take independent decisions to sell any of their holdings. The balance is widely dispersed. As a result of this shareholder structure, share turnover is low. Only around 10% of the shares are traded in a year. There are no transactions on one third of trading days. The bid-ask spread is, consequently, wider than average – possibly as high as 15%.

Let's then say Company B has no sizable



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shareholder. Its shares are distributed among thousands of investors. Market turnover is relatively high, with 60% of its shares being traded in a year.

In trying to buy shares in Company A, an investor could easily be forced to pay 10% or even 20% more than the last traded price on relatively small retail volumes. Buying Company B, on the other hand, will prove more straightforward. Purchases will have a minimal impact on market prices.

Executives of Company A will be inclined to say: "I told you so: a tight capital structure produces a better return." But that only holds if investors decide to buy shares without regard to a widening discrepancy in relative valuation or they are unconcerned about the higher transaction costs that come with buying an illiquid stock.

In other words, Company A is positioning itself to attract an explicitly irrational investor prepared to incur costs unnecessarily. Company B, the one with the less tight capital structure, ought to be the preferred investment alternative.

Company A also comes with more downside risk. Low liquidity can often give the appearance of a relatively stable share price if no-one wants to trade. In weakening markets, as buyers become increasingly reluctant, even a small amount of selling can have an unusually large negative effect. Companies with lower liquidity will often fall more dramatically than their peers in periods of prolonged market weakness.

A company with an unusually large number of shares will probably be a company with a history. A large number of shares may be a sign of poorly invested capital or previously failed exploration or development efforts.

Lithium Australia and Pilbara Minerals illustrate real-life market reactions. Both are attempting to position themselves as global lithium miners. Lithium Australia has 133 million shares on issue. Pilbara Minerals has 716 million shares, of which 320 million were issued in connection with non-lithium projects, including gold exploration activities in Papua New Guinea that have since been abandoned. An individual share would have been worth more today without the earlier history, but future investment returns will only be affected if investors extrapolate the prior track record to infer a similar investment failure rate.

Since the end of 2014, the Pilbara Minerals share price has risen 710%, putting the company's return among the best 10 in the sector listed on the ASX. Lithium Australia, meanwhile, has produced a still impressive but more pedestrian 110% return.

Pilbara Minerals is an example of how investors will discard history if confronted with a sufficiently favourable future irrespective of the number of shares and their original source. In this instance, the better return has come from the stock with the allegedly less tight capital structure.

**"Companies with lower liquidity will often fall more dramatically than their peers in periods of prolonged market weakness"**

If the tight capital argument holds water, the best performing stocks should generally have fewer shares on issue than those with the worst investment outcomes.

The 20 ASX-listed stocks with the best investment performance during 2015 have an average number of shares on issue of 639 million. The median number of shares on issue among these companies, on my reckoning, is 501 million. The 20 stocks with the worst investment performance had an average 679 million shares on issue and a median number of shares of 424 million.

At 6%, the difference between the averages has been barely significant. The median is three times more significant but not in the anticipated direction. In short, investment performance has been unconnected to the number of shares on issue. ▼

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