Choice hides poor quality

Syndicated Metals chief executive Andrew Munckton told an audience of investors recently that only two projects out of 30 he had reviewed were worth a second look.

John Robertson* | 24 Nov 2016 | 10:35 | Opinion

A huge variety of options doesn't guarantee investors quality

Munckton's search culminated in the purchase last August of the Monument gold property in the Laverton region of Western Australia, one of the two he had earmarked for further study.

Knowing more about the appraisal process would have been a worthwhile insight into the investment characteristics of the industry. Unfortunately, Munckton decided he did not want anything written in *Mining Journal* about his assessment process or the reasons such a high proportion of projects had failed to meet his standards.

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Munckton's comments, nonetheless, remained of interest because they reinforced similar observations by others pointing to a plethora of available mining assets but a dearth of investment-grade opportunities.

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Speaking at Australia's International Mining and Resources Conference in November, Denham Capital managing director Bert Koth described how tough it had been for his group to identify investment opportunities in the industry.

As private equity investors, Denham looks first for experienced operators with a successful track record. Having chosen to back only about 1% of those available, Koth reckons the firm looked at some 1,300 projects from which it chose just a handful.

Speaking at Mines and Money in London in 2015, BlackRock fund manager Evy Hambro said 90% of the exploration companies he had met were unable to validate the claims contained in their public filings during due diligence.

"The stockbroking approach is heavily flawed"

Richard Schodde of MinEx Consulting has drawn on his extensive historical database to conclude that the Australian mining industry has averaged around 15 significant non-iron ore mineral discoveries annually over the past 30 years.

The number of discoveries by Australian companies appears to have changed little, according to Schodde's analysis of the data, despite the number of listed companies more than doubling through the most recent cycle.

In other words, the likelihood of any single company making a discovery appears to have more than halved.

Even if the implausible were to happen and every ASX-listed company was eventually successful, some companies may need 25-30 years or longer to fulfil their promise, at the prevailing discovery rate.

The anecdotal evidence from within the industry and more formal statistics, where they are available, drive toward the same conclusion, namely, that the vast bulk of the industry's offerings fall short of acceptable investment quality.

Large variations in investment quality are not peculiar to the mining sector. In financial markets, for example, investors can buy lowly-rated Greek government bonds as well as top of the range US-government paper. High-quality corporate bonds trade in the same markets as junk-bond issues.

Explicit recognition of quality and risk variations through the availability of investment ratings from independent agencies is the outstanding difference between investment appraisal in the bond market and the approach to mining equities.

Admittedly, rating agencies like S&P, Moody's and Fitch faced intense criticism in the aftermath of the 2008 financial crisis. In some instances, becoming too engrossed in the products they had been asked to rate caused a loss of objectivity and misleading conclusions about risk.

A bias toward unjustifiably favourable ratings led otherwise risk-averse investors astray but the rationale for risk-rated securities has remained strong.

Investors do not necessarily dismiss out of hand a CCC-rated debt investment. Rather, an understanding of the risk profile helps inform decisions about how much to pay.

As long as the prospective return is sufficient to cover the relative risk, investors could reasonably choose a CCC-rated bond in preference to a AAA- rated alternative.

While mining industry investors must also make judgments one way or another about asset quality and market risk, similar conversations to those in the bond market are never initiated and rarely facilitated by the companies themselves.

The absence of adequate risk assessment led me to launch the PortfolioDirect stock rating framework several years ago. The aim was to do for Australian-listed resources companies what S&P had done for global bonds.

Now, professional money managers can access an industry-wide and consistently applied rating framework.

How a stock rates on the PortfolioDirect risk adjusted quality scale does not tell anyone whether they should 'Buy' or 'Sell' in the way stockbrokers use research to promote investments.

The stockbroking approach is heavily flawed.

For a start, brokers are too close to the industry. Despite a minus 87% median share price movement through the cycle, a 'Sell' recommendation is perplexingly almost impossible to find.

Even in the absence of such a recommendation bias, broking analysts are not in any position to know whether investors should buy or sell a stock as they are typically blinded to the varied risk profiles and investment objectives of those using their research.

All an analyst can reasonably do is assess a company's asset quality and investment riskiness. Armed with that information, financial advisers or professional money managers, who actually do know their clients, can choose stocks to suit their purposes.

Sometimes, the choice might be a mature, well established company used to gain exposure to the cycle. At other times or for other investors, earlier-stage development opportunities or companies with returns leveraged to exploration success might better match investor risk profiles.

The apparent variability in mining industry asset quality and risk profile – so widely documented by so many qualified observers of the industry – cries out for a research emphasis explicitly recognising differences in quality and risk characteristics.

Shining a revealing light on the wide range of quality and risk characteristics within the industry might make some promoters uncomfortable but, as in the bond markets, would help investors to more efficiently price the assets on offer.

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