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Why the overexcitement?

Orocobre, Western Areas, Syrah Resources and Independence Group have attracted unusual amounts of short selling with the first three companies among the four most heavily shorted of all ASX-listed stocks.

John Robertson* | 27 Apr 2017 | 5:36 | Opinion

Short sellers only take advantage of stocks that get above their station

"Criminal" was the recent description of short sellers by Australian retail industry billionaire Gerry Harvey, head of the ASX-listed Harvey Norman household and electrical goods retail chain.

Executive critics of short selling often feel betrayed. By definition, stock used in short sales can only be lent by existing shareholders who are otherwise feigning loyalty to the company's strategy and business plans.

Short selling may signal dissatisfaction with poorly performing company management but even accomplished managers credited with more than they can achieve by overly excited investors may find their companies targeted.

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The Gerry Harvey reaction, although common among company executives, is at the polar extreme to that of economic analysts who believe short selling contributes valuably to a more efficient market.

Short selling can add volatility. Unanticipated exogenous events with a positive effect on mining sector prices can force short sellers to urgently unwind their trades. The upward retracement can be far speedier than the downward slide.

According to an Australian Securities and Investments Commission (ASIC) report dated April 12, the three mining companies nearest the top of the short-selling list had the equivalent of 15-21% of their stock shorted. Independence Group, which ranked 13th on the ASIC list of 465 companies, had a 9.7% short position.

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Ironically, these four mining stocks are among Australia's most successful.

All but Syrah Resources are already in production. Syrah is well on the way to mining the world's largest graphite resource.

The anticipated multi-decade life of Syrah's Mozambique property catapulted the company from a market capitalisation of A$3.3 million (US$2.5 million) to $1.5 billion. A 160% annualised return between late 2011 and mid-2016 placed the company at the head of the return rankings for the entire ASX-listed resources sector.

Therein lies much of the motivation for short selling, namely, the potential for over exuberance in a market prone to faddish behaviour and in which success stories are rare.

Independence Group houses two of the most outstanding mining discoveries in the recent history of Australia's industry: the Tropicana gold mine in which the company has a 30% interest and shares with AngloGold Ashanti (70%) and the Nova/Bollinger nickel-copper deposits acquired in its takeover of Sirius Resources in September 2015.

Independence, with a market value of A$1.83 billion, has reported underlying cash earnings for the six months ended December 2016 of $82 million. Extraordinarily strong growth expectations are still embedded in the current market value despite a 33% decline in the share price since November 2016.

Extracting value from the Sirius Resource purchase was always going to be a challenge.

In August 2015, I questioned in Mining Journal whether Independence Group had made the right choice in buying Sirius Resources having observed how the company was paying $1.96 billion to get assets with an appraised value of $1.72-2.44 billion when it could have been buying a dozen Fraser Range explorers for as little as $120 million.

Dramatically bulking up its size through Sirius would consolidate the company in institutional portfolios but require it, against all odds, to do almost everything right simply to validate its existing market price.

With private investors now making up no more than 15% of its shareholder base, news flow, the staple of mining juniors attempting to sustain a profile, would become less important than value as a driver of returns.

Orocobre is another that had been priced to meet expectations of perfection, as I pointed out in a February 2015 Mining Journal column. At the time, Orocobre had not made its first sale, yet the anticipated earnings of the budding lithium-carbonate producer were more highly priced than the existing earnings of well-established global chemical companies such as DuPont and Dow Chemical and in line with the price being paid for the earnings of global market heartthrob Apple.

Writing about Orocobre a year later, I concluded that scepticism was probably the more appropriate default position after some of the more obvious risks were being realised.

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In each of these cases, there had been evidence of prices surpassing valuation boundaries by a sufficiently large margin to pique the interest of traders.

The admission of these companies to benchmark stock price indices and their attractiveness to institutional investors due to their burgeoning market values made them more likely to attract the attention of traders just as willing to profit from rising as falling prices.

Institutional ownership, with its accompanying professional custodial arrangements, also enables the stock borrowing, which facilitates short selling.
Orocobre, Western Areas, Syrah Resources and Independence Group are all constituents of the ASX small resources share price index. All have produced negative returns over the past 12 months and have underperformed the index by between 20 and 60 percentage points.

Even amid recently buoyant equity markets globally, rising prices for higher-risk corporate debt and a rebound in a wide range of commodity prices, the index has made no net gain since early June 2016.

The extent of short selling among overpriced stocks has contributed to the lacklustre index performance.

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