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MOD shareholders given easy choice

More industry mergers would be evidence of dimming memories fostering repetition of past errors.

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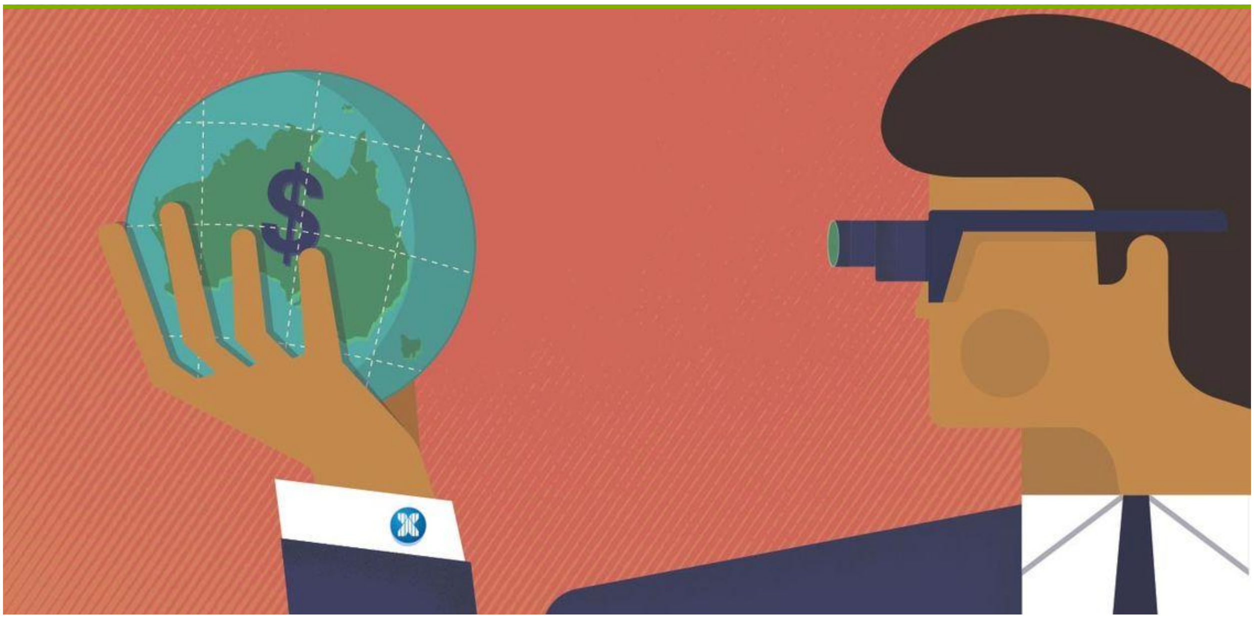

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In a recent clearout of long-hoarded papers, I came across a 1982 article penned by economist Walter Adams criticising an outbreak of corporate mergers, many of which involved the oil and gas and mining industries.

Adams, who had earlier testified before a series of US Congressional hearings on the subject, characterised the early 1980s merger trends as self-serving attempts to impede competition, fostering economic inefficiency and stagnation as funds were diverted from productive investment.

Coincidentally, within a few hours of recovering the Adams article, I read a Mining Journal commentary by Chris Cann, head of Aspermont Research & Intelligence, in which he concluded that industry-wide M&A was set to dominate the 2019 landscape. Here we go again, I thought.

As well as the bout of recent big company gold mergers contributing to Cann's conclusion, Sandfire Resources has made a pitch to bulk up its copper exposure through a MOD Resources takeover.

A September 13, 2018, 'From the Capital' column discussed the strategic predicament confronting Sandfire. By many standards, Sandfire is one of Australia's most successful miners of recent years, having moved swiftly from discovery of the DeGrussa deposit in 2009 to a 2012 production start. The Western Australia mine now underpins annual copper production for the company of around 65,000 tonnes. Unfortunately, the end of a short eight-year life is in sight.

In 2012 and 2013, the company was talking excitedly about the prospectivity of the Bryah Basin region, in which DeGrussa occurs, and the likelihood that it would be just one - and by no means the largest - in a cluster of high-grade volcanogenic massive sulphide finds.

That early optimism about the regional discovery potential has not eventuated. The promise of something bigger and better could yet be realised but obscure timing, disliked by investors and executives worried about their employment tenure, has prompted efforts to secure a strategic safety net with assets being picked up elsewhere in Australia, North America and Europe.

> **Too few companies have successfully moved speedily from discovery to development**

Against this backdrop, a tilt at Botswana copper mine developer MOD Resources is understandable. The open question is whether Sandfire is historically unusual in being able to source value through a merger or is simply replicating the errors outlined by Adams nearly 40 years ago.

Mining industry mergers are handicapped by being unable to count on synergistic opportunities of the type used to justify manufacturing deals. Manufacturers can use mergers to reorganise production bases to achieve lower costs or improve market access. These are not opportunities open to miners destined to operate where, and on a scale, Mother Nature dictates.

Absorbing MOD Resources would not affect the operating life of DeGrussa. Nor would it impact greatly development plans for the T3 copper mine in Botswana. Since operational synergies from a combination are inconsequential, there is no gain for the people of Botswana, either.

A takeover would also eliminate the freedom of investors to decide for themselves, based on their individual circumstances, how much of each asset they should hold. A merger would compel investors to hold the relevant assets in the proportions dictated by the directors of Sandfire or not at all, for a clear loss of investor welfare.

Without synergies, there is no loss of underlying value from MOD and Sandfire continuing to trade separately, only a redistribution of where the benefits would otherwise accrue.

A takeover would also have a detrimental effect on the standing of the sector as an investment destination. Too few companies have successfully moved speedily from discovery to development to draw new investors to the sector. Sandfire happens to be one of the rare few. Eliminating the possibility of MOD replicating the Sandfire experience and extracting full value for its efforts would be a negative signal to investors about prospective returns, more generally, from the sector.

Based on the company's January 2018 pre-feasibility study for the T3 Botswana project, a US$168 million equity and development capital investment today would entitle a MOD investor to approximately US$500 million, after tax, over 14 years from the company's 70% interest.

Sandfire currently has cash assets of approximately US$160 million. Cash flows from DeGrussa, to be supplemented in the coming year from the nearby Monty property, are currently running at approximately A$240 million (US$174 million) a year. Development of a contemplated copper property in Montana, if it proceeds, would require a spend by Sandfire of US$187 million to produce around $590 million over 11 years, according to a 2013 study.

Existing MOD shareholders would have a choice, in the event a bid is formalised on the reported terms, between 100% of US$500 million over 14 years, on the one hand, and 8% of just over US$1.5 billion over much the same timeframe.

A favourable recommendation from MOD directors on even more generous terms than those currently on the public record could suggest considerable self-doubt about their ability to deliver the T3 project.

Another consideration for MOD shareholders is that the incremental project value is likely to have a far larger impact on MOD's A$83 million market capitalisation than Sandfire's A$1.2 billion.

Sandfire Resources investors, themselves, could have reason to doubt the wisdom of the proposed transaction, and possibly the broader strategy being pursued by the company.

Notionally, shareholders of the bigger company could be entitled to cash of US$850-900 million within four years at the close of the DeGrussa mine or, based on current plans, they could wait for US$1.5 billion over 14 years. The latter choice implies a modest post-DeGrussa investment yield of around 7.5% on the capital employed putting the company in a crowded field of others with similarly tepid investment offerings.

The case for Sandfire running the show is weak. The only clear beneficiaries, among all the stakeholders, would be executives of Sandfire because personal remuneration is almost universally aligned to asset size and only rarely linked to effective use of capital.

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