

Mining - growth by acquisition

Ernst & Young is a leading advisor in the mining sector worldwide, and looks at trends and activity in the industry on a continuing basis. As part of this process Ernst & Young is sponsoring research in the Royal School of Mines, at Imperial College, London.

At the moment, conventional wisdom seems to be that a large proportion of merger and acquisitions activity leads, paradoxically, to shareholder value destruction. Ernst & Young decided to look into this in the context of the major listed mining companies. We investigated how the aggressive ‘acquirers’ have performed relative to the more cautious, or perhaps conservative, companies. We took 48 listed mining and metals companies with a combined market value of over US\$850bn. Seven of these organisations had completed deals representing more than 25% of their individual market value during the past seven years. These were taken to represent the ‘acquirers’, and the remaining 41 companies were combined as the, imaginatively named, ‘non-acquirers.’ We then looked at the total shareholder return (TSR) over the test period: that is, the increase or decrease in market price of the shares plus dividends reinvested in the company. TSR was used as the benchmark so as to recognise those companies that may have returned excess cash to shareholders in the form of dividends rather than making acquisitions.

The two indices are weighted by market capitalisation, are US\$ denominated, have a base date of 1 January 1990, and a base value of 100. The difference in performance is impressive. The returns to shareholders from acquirers have clearly outgrown those of non-acquirers. Now, this is certainly an arresting observation, but this marked divergence of performance does not of itself mean that the way to create value for the shareholders in mining companies is for the businesses to go on a buying spree. It is likely that the most active acquiring companies are those that already have a

proven track record in successfully integrating acquired assets and delivering synergies. Coincidence of events does not necessarily indicate cause and effect, but nevertheless, during the recent period of rising metal prices, it is clear that those companies determined to acquire control of scarce resources have read the markets well.

The acquirers sometimes appear to be paying more than the net present value (NPV) of the target, and the question arises as to whether they are overpaying. The acquirers appear to be not only filling the gaps in their resource bases, but also may be looking to achieve other objectives, for example to:

- diversify currency, commodity and country risks;
- grow the scale of the business and benefit from market re-rating (and perhaps credit rating improvement), and as a result, gain access to the feedstocks for other downstream operations;
- achieve synergies and efficiencies;
- and maybe to expose the business to the option value of product price volatility.

Major mining companies have always sought large reserve bases for long-life operations, even though conventional NPV analysis places little value on reserves and resources that can be extracted further out than, say, fifteen years. But large reserve bases do confer great advantages, for example:

- to give the option to increase production rates in the future;
- provide more certainty over the reserves;
- provide some pricing power;
- give some protection against market weakness through ‘high grading’ in bad times;
- attract long-term offtake agreements;
- and of course, through simple economies of scale.

Some companies have elected not to participate in the recent acquisition activity, at least not at the prices concluded at the time. The underlying reasons for the differing attitudes to merger and acquisition activity may be reduced simplistically to: the varying cost of capital applied, sometimes arising from the different levels of risk analysis used to allocate discount rates applied in NPV calculations; and a polarisation of opinion as to the future direction of the metal prices, particularly in the medium term.

It may be that the rapidly growing mining companies are those that have been better at determining the long-term value of mining assets, whilst others have been too timid in their planning assumptions. Ernst & Young intends to follow and investigate these aspects further.

Below: Mining Acquirers compared with Non-Acquirers - Source: Thomson Financial Datastream.

