

THE MINING INVESTMENT ANALYST

Different or the same?

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The Background Setting

In the dim dark days B.K.(Before Kambalda) mining investment analysts were pretty rare creatures (I use this to describe their relative strength and frequency and not as a derogatory description of them personally).

The development of new mines, especially iron ore and coal, Esso-BHP's successful oil exploration in the Bass Strait, the particularly buoyant metal prices which prevailed from 1967 to 1970 coupled with the discovery and development of nickel deposits at Kambalda and elsewhere rapidly changed the face of the mining investment scene in Australia.

Almost overnight there occurred a demand from investment institutions and companies, but particularly from stockbrokers' offices, for persons who understood or appeared to understand what mining was all about and who could evaluate in a stock market investment sense, mining company discoveries, development potential and future earning capacity.

Before the mining boom, investment analysts with few exceptions had a background in economics, accountancy or similar fields and were trained either formally or by practical application in the accepted doctrines of analysis e.g. balance sheet and earnings analysis etc.

As regards "traditional" analysis, the mining boom had two effects:-

(a) Analysts were required who knew the definitions, terms and significance of mining operations i.e. the geology, engineering and metallurgy.

Consequently, many technically oriented people to whom the stock market and investment analysis were completely new worlds were recruited to the ranks of stock-broking and stock exchange investment.

(b) "Traditional" type analysis during the currency of the boom was relegated to the background and was overshadowed by the new mining analysis, irrespective of the quality of the latter.

Many of the new entrants to the investment scene, although professional and ethical as far as their previous occupations were concerned, were out of their depth when it came to evaluating mining enterprises on any basis other than a highly optimistic one. The fault for this of course, did not lie completely with the new analyst but was largely because he thought and was encouraged to believe that a highly optimistic approach was expected in the circumstances (which were, it might be remembered very buoyant and hectic).

Since the demise of the mining boom, many if not most of the new recruits have found themselves no longer required by their boom-time employers and have gone back to their former calling, so that the number of mining investment analysts now extant is well below the number of two to three years ago, but is nevertheless still greater than the number of six to seven years ago.

Numerically, the mining investment analyst is still outnumbered by his industrial counterpart and this is largely a function of the number of listed industrial companies and their respective exchange turnover relative to mining companies.

Amongst others, two conclusions regarding the mining analyst can be drawn from experience, during and after the boom excesses:-

(a) The mining analyst is here to stay, although as noted above probably in smaller numbers than his industrial colleague.

(b) With some notable exceptions, the concepts and philosophies underlying mining investment analysis are not as clearly understood by the institutional investor as those underlying industrial companies.

The Question

This raises the question- is the mining analyst unique and of a different species than his industrial counterpart or is he just a variation of the same species?

A Few Definitions

Before proceeding any further, it is worthwhile defining what sort of mining analyst I have in mind. Many of the boom inspired entrants into mining investment (and who have since departed for other areas of activity) should be more rightly called " mining speculation advisors ". Little qualification was needed for this task except the ability to pick a stock which had some prospect of increasing in price - this wasn't hard to do when the boom was on full steam.

In my view, there is a greater difference between a mining analyst and a mining speculation advisor than there is between a mining analyst and an industrial analyst.

As far as mining analysis is concerned the comments that follow apply largely to producing, investment grade miners, and exclude non-producing miners, although for a minority in this latter category, from time to time there may be cause for examination of their prospects by the analyst, with the aim of assessing the speculative potential.

In this article, I am looking at the Australian experience only, and the comments do not necessarily apply to mining analysis in U.S.A. Canada, U.K. or South Africa.

Another aspect which makes the dividing line less clear is the growing tendency for mining companies to diversify into industrial activities e.g. North Broken Hill and Broken Hill South, and for industrial companies to invest in mining e.g. Colonial Sugar Refining Co. Perhaps this is a recognition, for different reasons, that earnings of a mining enterprise do tend to fluctuate, on average more than those of an industrial, but that the potential for achieving a higher rate of return on funds invested lies more favourably with a mining activity (if it is successful).

Many areas of similarity between the mining and the industrial analyst come to mind. It is not necessary to detail them, since the similarities relate mostly to a common aim, which is to assist in the definition of specific investment objectives and selection of securities which will maximise the return over a specified time scale, commensurate with the risk involved, and within the overall investment objectives.

The areas of dis-similarity can best be considered under three headings - nature, techniques and people.

Nature

Investment analysis in its present form in Australia is a fairly recent phenomenon and is only about twenty years old. Originally it borrowed heavily from and still relies to a large extent on techniques and attitudes of investment analysis in USA. In USA and consequently in Australia the aim of the institutional portfolio manager and consequently the analyst, be he institutional or broker-employed, has been to find stocks in which:

- (a) the financial position is sound,
- (b) earnings and dividends per share will grow at an acceptably high rate,
- (c) earnings per share will grow without significant set-backs,
- (d) earnings per share can be predicted with a high degree of accuracy.

Although many industrial companies do not conform to this model, the number of mining companies which do would be even lower. The earnings of mining companies as a group will tend to fluctuate more around a trend line than will industrial companies as a group. Bearing in mind the variabilities in input, particularly free market metal prices, ore grades etc, it could well be that a mining analyst who forecasts earnings to within 20% of those declared by the company may be more worthy of praise than an industrial analyst who forecasts to within 5% variation the earnings of a brewery or finance company.

With some exceptions, the industrial analyst is concerned with companies which are operating solely in the Australian environment and are immune, except in a general sense to world economic events. In contrast, the miner probably sells most if not all of his output overseas, or in any event, the fortunes are more subject to events over which the company has no control (and which is harder for the mining analyst to predict.)

Another difference in analysis which arises from the different nature of mining and industrial operations is that the industrial analyst is usually content to forecast, in specific terms, earnings only one or two years ahead. The mining analyst has to be prepared to forecast earnings perhaps up to five years ahead, or at least give some estimate of the potential order of magnitude of earnings at that time, perhaps resulting from announcements by the company about a planned expansion program.

Perhaps the main difference, however arises from the fact that most mines have a limited life and although the company as an entity may have a continuing existence, the orebody which is the main asset of the mine does not. On the other hand there is the ever-present possibility that exploration will result in the extension of existing orebodies or the discovery of completely new ones. In both cases, a reassessment of the company's potential must be made. Because the earnings contribution from the new discovery is not immediate, earnings projections must of necessity be made for some years ahead.

Techniques

It seems a paradox that the mining analyst almost invariably has much more information on which to base his assessment e.g. production figures, average metal prices, working costs (sometimes) yet his earnings estimates may be wider off the mark than those of his industrial counterpart who may have less information available to him.

The answer here seems to be that because he has more information available, the mining analyst is more willing to set up his own "earnings model" and calculate earnings per share, or an "intrinsic worth" of the company on a discounted cash flow evaluation, based on his own assumptions as to production rates, metallurgical recoveries, metal prices etc.

In contrast, the industrial analyst because of the lack of information has to estimate future earnings rate of growth by relying to a large degree on extrapolation of past trends, modified up or down where appropriate.

There seems no valid reason why industrial companies should not be assessed on a discounted cash flow basis in the same manner as mining companies, yet this practice appears not common in Australian investment circles. The discounted cash flow approach while having shortcomings based on the quality of input assumptions, does have benefits to the analyst in that for example, the need for future finance raisings can be foreseen.

While industrial analysts may place a large measure of reliance on past performance to gain an insight into likely future trends, for the mining

analyst the past is of lesser significance. Therefore the mining analyst is more inclined, and in fact is virtually compelled, to look to the future and at that more than just one or two years ahead.

Associated with the mining analyst setting up his own "model", whether it be a complete discounted cash flow or a "declared earnings" calculation covering only the next three or four years, is the advantage that sensitivity of earnings to changes in various factors e.g. metal prices, production/sales, working costs can be readily defined. In other words, the mining analyst can say that he has calculated certain values for earnings per share, but if the reader of his analysis has differing views on the assumptions used he (the reader) can calculate accordingly his own "adjusted" values. The use of sensitivity factors could well be adopted by industrial analysts.

One of the advantages of the discounted cash flow evaluation is that provided the input assumptions are valid, an "intrinsic" value can be calculated which is not based on subjective parameters such as the right or appropriate price earnings multiple to apply to earnings, either present or future. The mining analyst having done his "objective" assessment as to the "intrinsic" value can then apply his separate "subjective" assessment as to how investors might view the company on factors other than earnings magnitude and trend. The discounted cash flow approach provides a backstop or base value in line with the investor's required rate of return.

In contrast to the industrial analyst, the balance sheet of a mining company is of lesser importance to the mining analyst, except to the extent that the figures disclosed therein will either help or hinder the company in realising the earnings of which it is capable. The analytical emphasis for the mining analyst should be on net cash and liquids and the company's ability to pay its way in the short to medium term, rather than on the fixed assets value as shown in the balance sheet since these have little connection with replacement cost, scrap value, value of ore being exploited or the ability of the company to maintain necessary liquidity.

People

It is probably fair to say that most of the industrial analysts have either economics, commerce, accountancy or finance qualifications, and many mining analysts are similarly qualified.

On the other hand, a substantial proportion perhaps the majority, of mining analysts in Australia have a technical background in the mining industry e.g. geology, mining engineering or metallurgy. It is only natural therefore that these technically oriented analysts should have an approach and style which is different to that of the traditionally trained analyst.

In fact, at least in my experience, any difference in conclusions between the technically trained mining analyst and the traditionally trained mining analyst usually resolves itself to matters of opinion rather than fact, and these can usually be readily reconciled.

In contrast to other areas of stock exchange investment, it appears that mining is the only area in which the majority of analysts have actually worked in that industry. How many industry specialists are there in Australian institutions or brokers' offices who have actually worked in that industry e.g. pastoral, banking, retail?

Further Considerations

For all the similarities and differences, either real or imagined between analysis of mining and industrial securities, it seems clear that as far as portfolio investment in mining companies is concerned, an attitude somewhat different to that used for industrial companies is necessary.

Unfortunately, many investment managers seem to regard mining companies as imperfect industrial companies, because of lack of real understanding of the nature of mining and mining investment. Perhaps too many fingers were burnt by the excesses of the mining boom. This is a pity because if time and trouble is taken to understand what mining is all about (and this includes looking at both the relative risks and rewards) it is possible, in fact more than likely, to make more money out of mining than out of any other avenue of stock exchange investment.

However, to achieve maximum return means taking on counter-cyclical, rather than a bandwagon approach i.e. accumulate stock when metal prices are down and prospects are gloomy, and sell when metal prices are high and prospects buoyant. Unfortunately because it is difficult to pick the right time to buy and because economic cycles do not change direction overnight, the portfolio manager in Australia at least, defers his decision to buy until it is obvious that all the signs for a sustained advance in mining share prices are favourable. This of course means that he doesn't have a period of holding mining shares when the prices paid may be higher than the current market, but it also means that his potential gain, the main reason for investing in mining stocks, may be considerably reduced, and may not be worth the risk.

In contrast, U.K. institutions and mining houses are more prepared to invest in mining issues on a counter-cyclical basis with probably a much better performance record than their Australian counterparts.

It is unfortunate for the mining analyst that over an average five year metal price cycle, only a nominal interest will be shown by portfolio managers in investment in mining companies during say the three years when the mining outlook is unexciting. During this time the mining analyst may well wonder whether he has chosen the right occupation, because of lack of interest by others in what he is doing. During the other two years of the cycle he will probably be overworked and may be wondering whether an occupation where the work load is spread more evenly over time might be preferable.

Perhaps because mining and mining investment has not been understood as clearly as it should be in Australia, the mining investment analyst has sometimes had to spend too much time and effort being an advocate of mining rather than seeing clearly the relative contribution of mining in the whole portfolio investment scene.

Final Thoughts

In conclusion it seems there is room for the mining analyst to learn from the industrial analyst, especially in the area of traditional analysis, while a better understanding of the differing nature of mining on the part of the portfolio manager would make the mining analyst's contribution to the investment scene more effective.

As to whether the mining investment analyst is the same as or different from the industrial analyst, the answer to me seems to be that they are the same in perhaps many more respects than either would care to admit, but there are differences mainly in technique and attitude which in turn is due in no small measure to the different nature of mining as compared to industrial activity.

Perhaps an appropriate analogy might be the front and rear engined car. The aims, principals and techniques of engineering and propulsion are identical in most respects but there are differences in how the objectives are achieved.

On reflection perhaps this article has not been as provocative as it could have been. But I have to be careful; some of my best friends are industrial analysts.