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The Alchemist

Australian Natural Resources Mergers and Acquisitions

Does it create value for shareholders?

Executive summary

Australian natural resources mergers and acquisitions have been in focus recently, with a number of high-profile failures and successes raising the often asked, but rarely answered question – does M&A create or destroy value for shareholders?

To investigate, RFC Ambrian analysed acquisitions by ASX-listed natural resources companies over the period from 2019 to 2023. Our analysis sought to measure shareholder value and overall company performance against a custom market index by tracking share price movement in the period from directly prior to the deal announcements to one year after announcement.

Our assessment offers a window into the intricacies of the M&A environment in the Australian natural resources sector, inviting questions and prompting discussion about the complexities and trends that shape investment outcomes.

Key findings

- Roughly two-thirds of the deals analysed had eroded shareholder value against our customised benchmark by the one-year anniversary of the deal announcement
- Single asset acquisitions typically outperformed corporate takeovers in value creation or preservation – even considering corporate takeovers of single-asset companies
- Deal scale (relative to acquirer size), premium and company scale appear to be poor predictors of success with no clear correlations noted with outperformance
- Yearly M&A performance varied widely over an unsettled period with 2020 clearly the weakest and 2022/2023 characterised by a strong recovery and robust outcomes

Methodology and criteria for deal inclusion

- Limited to acquisitions made by publicly listed companies (to track share price changes)
- A bespoke index was developed for benchmarking, instead of utilising established industry market indices
- Key criteria for transaction inclusion:
    - Headline deal value greater than US$5m;
    - Acquirer must be ASX-listed;
    - Deal value greater than 10% of the acquirer's market capitalisation (for reasons of material impact); and
    - Focus on transactions completed within 2019-2023.

This resulted in 28 corporate and 33 asset acquisitions being included in the analysis.

Why a custom comparison index?

Attempting to quantify the value to shareholders from M&A is difficult, with any number of variables at play and a multitude of lenses through which to ascertain “value”. Typically, analyses of this nature seek to determine whether an investor could have achieved outperformance by simply investing in a broader benchmark rather than a specific company which concludes a material M&A transaction, or “would I have yielded higher returns by investing more broadly in the market?”.

What we have sought to do is to go beyond this generic analysis of company performance versus benchmarks, and instead zero in on the specific performance of the deals by answering the question – “would my holding in this company have performed better or worse if it had not done the deal?”

To this end, we constructed a custom index that reflects a genuine mid-market peer group. It was designed to be free from the size-related biases of typical industry indices that are weighted to market influence, focusing instead on individual performance metrics. The index was compiled from data from approximately 700 ASX-listed metals and mining companies, fine-tuned to exclude outliers, thus offering a more suitable benchmark for this comparison.

We calculated the index by averaging individual company variances over the 12 months following each of the 61 respective transactions, rather than the overall index variance. This ensured a balanced evaluation of each company's performance against its undisturbed peers, rather than the wider market trend.

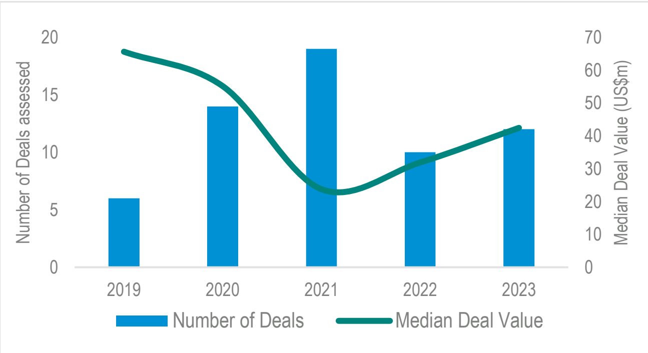

Figure 1: Number of deals and median deal value 2019-2023. Source: Refinitiv

Five year trends in M&A activity – an evolving landscape

Over the past five years, the global M&A sector has undergone significant fluctuations. A notable peak in activity emerged in 2021, a trend mirrored within our deal universe. Intriguingly, while 2021 was the top of the market for deal volume, it also saw the lowest median deal value, contrasting sharply with the higher values in previous years.

Could this shift be attributed to the resurgence of positive investor sentiment and loosening capital markets as the world adapted to COVID-19, thus reinvigorating smaller companies? Evidence appears to support this view; 2021 witnessed five additional deals compared to 2020, with four more in the sub-US$25m bracket, influencing the shift in median deal value. Deal volume reversion in 2022 and 2023, along with increasing median values, suggest a return to more typical market conditions. This shift could indicate that after the exceptional activity in 2021, fuelled by post-Covid exuberance, the market gradually returned to a state of pragmatic realism, reflecting a more stabilised and considered approach to M&A transactions.

Macroeconomic influences on deal activity levels

Several macroeconomic factors may have played important roles. Throughout 2021, historically low interest rates (with the RBA's cash rate at 0.1%) likely facilitated capital access, enabling many companies to fund transactions and associated work programs. Additionally, the surge in gold and copper prices in 2020 likely fuelled much of the upswing in M&A activity in 2021, considering that these commodities formed a significant part of our transaction universe and M&A activity often trails market trends.

The onset of COVID-19 in early 2020 caused a delay in strategic decisions and planned acquisitions. Many of these postponed transactions materialised in 2021, propelled by a growing optimism and anticipation of economic growth, culminating in a remarkable flurry of deal-making.

However, post-2021 witnessed a downturn in deal quantity, influenced by several factors. The increase in the RBA's cash rate to 3.1% by the end of 2022, coupled with a slowing economy and deceleration in ASX-listed companies' growth, may have contributed to this decline. Moreover, we argue that a growing scepticism of the merits of M&A began to emerge in this period, leading to a more cautious stance towards it.

In summary, the last five years in M&A activity present a complex tapestry woven by economic shifts, market reactions to global events, and evolving corporate strategies. These dynamics offer valuable insights into how external factors and market perceptions shape the M&A landscape.

So, what did we find?

Unsurprisingly, the data is not conclusive enough to pinpoint specific, correlatable drivers of acquisition success or failure. However, it raises several intriguing questions.

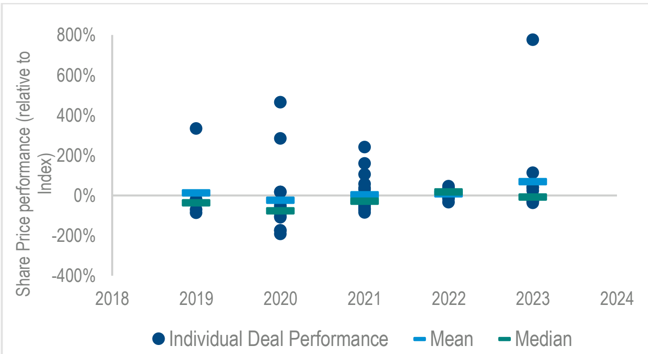

Figure 2: Share price performance by year for analysed acquiring companies relative to custom index
Source: Refinitiv

Does timing of the deal matter?

Deals concluded in 2022 present a stark contrast in performance versus those completed in 2020, arguably influenced by operational challenges during the height of the pandemic and fluctuating commodity prices.

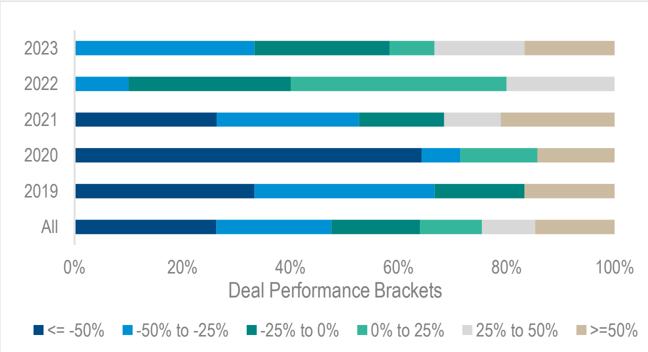

Figure 3: Deal performance brackets by year
Source: Refinitiv

In 2020, plagued by COVID-19 disruptions, including labour shortages and supply chain issues, over 70% of acquiring companies underperformed against the index, the vast bulk by over 50%. We also question whether this was exacerbated by falling gold prices throughout 2021 and the latter half of 2020 given two thirds of deals announced in 2020 were gold related, and many other commodities such as nickel, lithium and (until mid-2021 at least) iron ore were rising at varying rates.

Contrasting sharply with 2020, the year 2022 saw a reversal in fortunes, with the easing of COVID-19 impacts and strengthening gold and copper prices. This may have driven 70% of acquiring companies to outperform our benchmark, noting that 90% of analysed deals within this period involved gold or copper assets. Meanwhile, other key commodities like lithium, nickel and iron ore saw lower rates of increase or even declines in price.

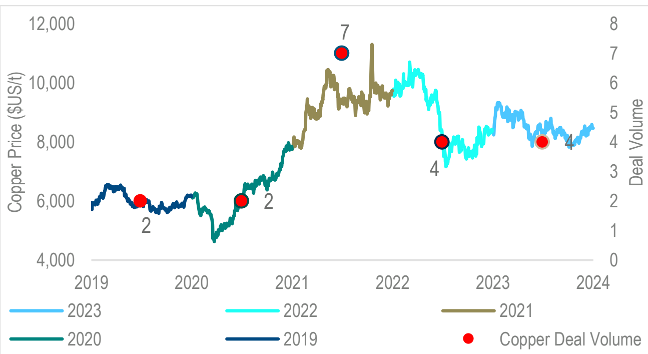

Figure 4: Copper price and copper deals by year
Source: S&P Capital IQ

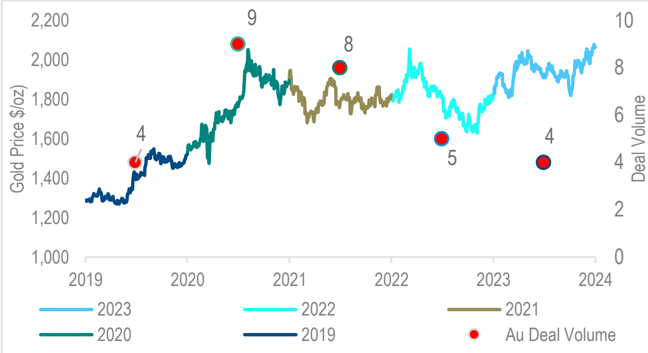

Figure 5: Gold price and gold deals by year
Source: S&P Capital IQ

Could the (mis)alignment with investor sentiment also have influenced the outcomes? In the tumultuous climate of 2020, investors may have favoured preserving cash or maintaining stable capital structures within their portfolio companies. As sentiments shifted and confidence returned, these same investors likely became more supportive of transactions they perceived as promising or strategically sound. We did take a look at share price performance in the immediate afterglow of the transaction's announcements, but no discernible pattern was evident, and no informed conclusion could be drawn.

Does deal size affect performance?

Our analysis reveals a distinct correlation between deal size and performance. Smaller deals, particularly those under US$10m, demonstrated considerable success against our custom index, with 67% of deals outperforming the index.

In contrast, larger deals, particularly those over US$500m, showed a clear tendency to underperform, with only 22% of acquiring companies' share prices outperforming the index and 44% underperforming by more than 50% relative to the index.

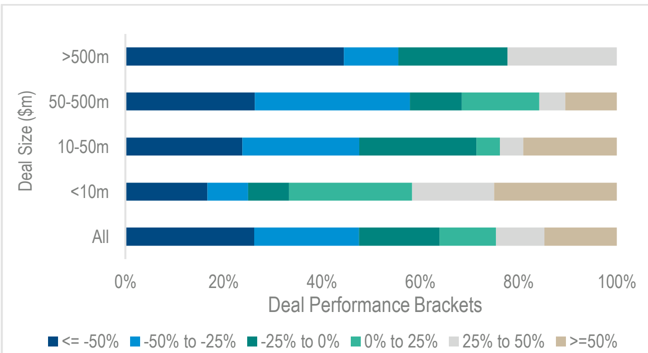

Figure 6: Share price performance by year for analysed acquiring companies by deal size and bracket relative to custom index
Source: Refinitiv

Why do smaller deals appear to perform better?

This pattern leads us to question the factors contributing to the success of smaller deals. Could it be their more straightforward, more manageable, and less disrupted integration processes, especially during the challenging COVID-19 period? If so, does this imply that larger deals, with their inherently more complex integration challenges, are at a disadvantage in periods of market upheaval?

We also posit that smaller deals simply have higher untapped growth potential for their investment, albeit with increased risk, that larger deals lack. This is often because the acquired assets, typically less developed or explored, have greater relative growth potential compared to assets in larger deals which may be more mature or higher quality, and so, likely more fully valued. Considering the wider selection pool of smaller entities, it is also entirely possible that they offer a better likelihood of matching a company's strategic objectives.

This perspective leads us to another significant advantage of smaller assets: they offer a way to diversify an acquiring company's risk without overstretching financial resources. This is crucial in an industry such as mining and exploration, where project risks are high.

Financing structures may also play a role; smaller deals tend to favour equity financing, avoiding the financial strain that debt financing can impose on larger acquisitions, particularly with rising interest rates between 2020 and 2023. This aspect is crucial for assets in fluctuating commodity markets, where resilience is less assured. It's possible that financial strains have contributed to the underperformance of larger deals.

Furthermore, the potential for scale leading to index-inclusion-related buying can inflate share prices, however, our analysis shows a greater number of smaller transactions, with less than 15% exceeding the value of the smallest ASX200 company so we don't see this as particularly pivotal in the outcomes we have observed here.

Table 1: Deal volume per deal size bucket
Source: Refinitiv

Deal Size Range	$5 -10m	$10 - 50m	$50 - 500m	>$500m
Number of Deals	12	21	19	9

Asset or Corporate Acquisitions?

In our analysis, a pronounced disparity emerges. 45% of asset acquisitions outperformed the index, a stark contrast to the 25% for corporate acquisitions. This divide is strikingly evident in the performance spectrum – asset acquisitions claim all top 10 spots in deal performance, while corporate takeovers languish in the bottom four. These results raise the questions:

- Are corporate acquisitions more prone to being overpriced?
- Are they often improperly structured?
- Does technical due diligence suffer at the expense of corporate due diligence?
- Have the deals simply been poorly executed?

The answer is likely to be a combination of all the above.

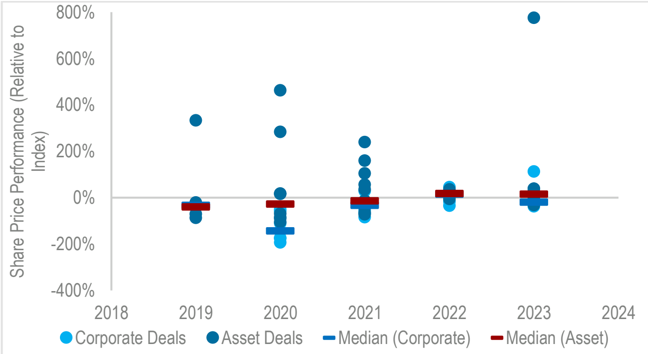

Figure 7: Share price performance of analysed acquiring companies by year relative to custom index - asset and corporate acquisitions
Source: Refinitiv

Unpacking the Divergence

Despite many corporate deals focusing on single-asset companies, where one might assume a level playing field in terms of due diligence and valuation understanding, they still lag asset acquisitions in success rates. Overpaying is always a common suspect in the post-mortem of underperforming acquisitions, but our data reveals that the takeover premiums - averaging 27% in two-thirds of corporate deals, and very often necessary to incentivise target boards and shareholders, especially in unevenly matched transactions - don't consistently predict success or failure. This complexity hints at a deeper narrative beyond just the premium paid.

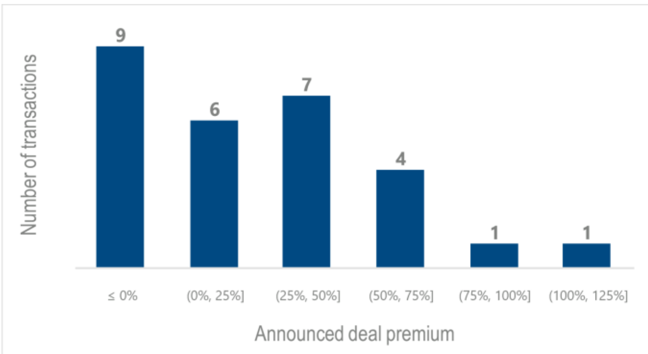

Figure 8: Corporate acquisitions - deal premia
Source: Refinitiv

Investor sentiment towards dilution in M&A also presents an enigma of sorts. While extra dilution from discounted capital raisings is often met with tolerance, scrutiny intensifies around M&A transactions conducted at a premium. We think this raises some interesting discussion topics:

- Does the typical larger scale and more substantial premium of an M&A deal compared to the relatively lower discounts in capital raisings simply attract more robust discussion and scrutiny?
- What about the optionality to minimise individual dilution in capital raisings?
- Do strategic considerations – such as the deployment (or return) of excess capital and the deal selection, pricing, and communication – play a more nuanced role?
- Does the broader messaging around M&A deals need to change?

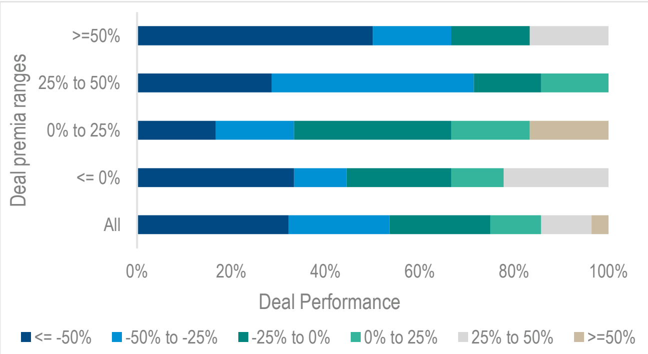

Figure 9: Corporate deal performance brackets by premia
Source: Refinitiv

It's true that selecting the right target at the right price, establishing a compelling investment thesis, and executing adeptly post-acquisition are cornerstones of a sound M&A strategy. Factors like strategic alignment with company needs, investor expectations and macro factors, actual realisation of synergies or inherent advantages that the acquirer brings to bear and effective post-deal integration are non-negotiable for aligning investor expectations with the pursuit of value creation. Yet, how much do these strategic components influence post-deal share price performance? Given the human element in the market, ineffective deal communication and simple misalignment with investor expectations or wants could be viewed as equally pivotal.

Are asset deals outperforming because they are better targeted, better structured, and better priced, thus resonating better with investors and company strategy? While the impact of specialised M&A teams and the inherent complexities of public market deals are well documented, the intertwining of tactical and strategic acumen with pricing fundamentals appears to continue to present challenges to acquisitive M&A actors.

On the basis of the data available to us, it's clear that simply having or not having a takeover premium in transactions doesn't have any bearing on the merits of a transaction for the acquirer. Instead, we should look at the broader picture, which includes the negotiation dynamics, the structure of the deal, and how well it's executed, along with market reactions and expectations. It's a complex interplay of various factors such as negotiation dynamics, deal structure, execution skills, and market perceptions, each affecting the ultimate success or failure of an M&A transaction.

Closing comments

Our review of M&A activity in the Australian natural resources sector shines a light on a landscape filled with inherent complexities and uncertainties. At RFC Ambrian, our expertise lies in navigating these intricacies, guiding companies to successful outcomes. We understand that successful M&A goes beyond meticulous due diligence; it encompasses deal selection aligning to company needs and market dynamics, optimal deal structuring, strategic and tactical execution, effectively managing post-acquisition integration, and adapting to ever-changing market trends.

Among the tools we utilise is our unique operational and technical asset analysis toolkit (available here), which complements our comprehensive approach to both pre-acquisition analysis and post-acquisition support. Our focus is not just on the transactional elements - operational, commercial, financial, or macroeconomic - but also on aligning them with the broader market trends, investor expectations, and specific challenges of the mining sector.

We aim to transform our extensive experience and expertise into practical and actionable strategies for our clients. We help them not only successfully execute M&A transactions, but also make informed strategic decisions for sustained long-term success in fully realising the potential of their ventures in this dynamic industry.

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