CORONATION
FUND MANAGERS

Grave dancing

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April 2011

How 'bout a little bit, a little bit of moonlight dancin' underneath the starry sky?
How 'bout a little bit, a little bit of moonlight dancin'?
Just the moon and you and I.
Mmm, just the moon and you and I.
– Bette Midler, from the album "Some People's Lives", song written by Diane Warren

In our investment parlance, a 'grave dancer' is one who invests in bombed-out and broken companies, in the expectation that they will recover. This particular form of value investing comes with obvious risk. By the time an out-of-favour company is offered cheaply, its prospects are typically dire. Reversion to the mean is a great concept in theory, but in the real world, challenged companies can fail and lose the investor's capital altogether. The art of grave dancing involves side-stepping the broken bottles so that you don't cut your feet. Given that we manage other people's money, the risk of capital loss must be weighed carefully against potential return.

This article is about the contract mining industry, and our increased interest in it. Coronation's involvement with contract mining started in mid-2008 when the former leasing division of Imperial listed as Eqstra Ltd. Prior to the listing, in 2007, Imperial had acquired MCC, a contract mining business, and injected it into this division. We were familiar and comfortable with the stable leasing businesses, and were able to satisfy ourselves that the newly acquired business had exciting prospects. We became enthusiastic investors in Eqstra, and its biggest institutional investor. The investment regrettably did not go smoothly: we negotiated various disappointments and supported a rights issue. At the time of writing, however, Eqstra's earnings recovery is firmly under way and its prospects look good.

In any challenged investment case, the first step is a thorough re-examination of the fundamentals. Our research typically includes contact with customers, competitors and suppliers. The initial work on Eqstra and later follow-ups thus led us to a broader understanding and a high level of conviction on the fundamentals of the industry. It also led us to the existence of investment opportunities in the competitors Buildmax and Sentula. And so we came to own not only one, but all three of them. This is a useful illustration of the investment process in action, and how we distinguish between cycles or mean reversion, and structural changes. But first we should explain what these companies do, and how they make their money.

Contract mining, as we discuss it here, is the business of digging topsoil, waste material and mineral-bearing ore (or coal) from open-cast mines. Typically the contract miner gets paid by cubic metre of material delivered to the desired spot, as agreed with the mine owner. The agreed rate encompasses the entire cost of buying and financing the equipment, and providing staff to operate, service and maintain it. At the end of the job, the contract miner sells the equipment for its own account, or moves it to another mine. The equipment is expensive, making the business capital intensive. It is also typically financed by debt, bringing financial risk into the equation. The business can be subject to the vagaries of rain in the pit, labour disruption and contract cancellation when commodity prices drop or the mine runs out. It can be a volatile and tough business, but if well managed, it can be rewarding with high margins and good returns on capital. Over the years the industry has had its cycles, but the business model has proved its worth and there is a place for it. Outsourcing is in fact increasing, making this a growth industry.

Why outsource? This is the first question one would ask. The answer is paradoxically that most mines don't. Long-life mines with stable ore bodies typically belong to first-tier mining companies with sufficient expertise and capital to undertake the ownership and operation of the equipment themselves. However, there are many (and increasing) instances where outsourcing makes sense. Contract mining provides

flexibility. If you produce a commodity with a volatile price, you may want to start up when prices are high and switch off when they fall. Particular ore bodies may have only a three or four year life; hence you'll end up with the resale risk on the equipment if you do it yourself. If you are a junior mining company, your balance sheet may not be sufficient to buy a fleet of mining equipment, or you may not have the in-house expertise to undertake the mining activity yourself. It may also be that you need big equipment for the first phase of mining and smaller equipment once the pit gets deeper. All these needs can be professionally met by the contract miner. The contractor, working say 10 different pits rather than just one, can optimise equipment usage more easily.

But easy it isn't. Practically the entire industry, whether listed or not, ran into serious financial trouble in 2009 and 2010. Eqstra, Sentula and Buildmax had to be recapitalised by rights issues. However, worse than merely a bad cycle, this downturn revealed serious problems with the business model of contract mining companies, and with its competitive dynamics and pricing power. To explain this we need to make a few sweeping generalisations, in the interest of simplicity. For many years, the contractors were family-owned companies, servicing their powerful corporate customers well, but in a somewhat unequal relationship. Implicit in the deal was flexibility: the contractors worked when the mine owners had work for them, and when there wasn't any, went to work elsewhere. There was no question of kicking up a fuss or holding the mining company to a contract: you simply had to retain their goodwill or risk not getting the job next time.

While the world was growing, this worked well enough. Used mining equipment could easily be sold, and their proceeds would lay off the outstanding bank loans. But a sure thing attracts many entrants and contract mining rates started drifting downwards. Existing players defended their market shares by cutting prices, eagerly pushed by the mining customers. Eventually rates no longer reflected the economics of the service and did not leave sufficient margin for replacing machines when they aged. Having created a perfectly competitive supplier base, the mining companies sat back in satisfaction. When the financial crisis struck, they shut their pits and blithely sent the contractors home, leaving them to face the consequences. But the cracks in the business model were revealed. The market for used equipment dried up, making it impossible for cash-strapped contractors to sell their surplus equipment. In trouble with the banks, they now had to raise capital from a position of weakness. And providers of fresh capital wanted assurances that their money would be repaid.

And so the cycle kicked upwards. The mining companies found that having viable contractors is actually in their interest. They now appreciated that no-one would spend a couple of hundred million without a proper contract with water-tight cancellation clauses. Higher rates were negotiated across the industry. Inefficient practices were washed out of the system, and management changes happened at almost every contracting company. Perhaps most important of all, supplier and customer sat down together and worked out a system where each would assume those risks appropriate to them, risks that they could manage more effectively. Contract terms, formerly skewed towards the customer, returned to a mid-point. It took a major crisis, but the industry emerged with much improved fundamentals.

Our work on a troubled investment helped us to understand that all the changes in this niche industry were not merely cyclical, but some were structural. The conviction that the industry would be improved, gave us the confidence to retain our investment in Eqstra, underwrite a rights issue in Buildmax and establish a new investment in Sentula; all at a time of extreme negativity regarding their prospects. We think that all three shares are cheap and offer large margins of safety. Their share prices have started to recover, but there is still a long way to go. Little bit of moonlight dancin', anyone?