

# Understanding resource company share structure

by Ron Hera

Evaluating junior resource companies is a complex process involving many criteria. Share structure, which includes the number of shares outstanding and fully diluted, major shareholders, insider ownership, resource value per share and capital investment efficiency, is a key consideration. Stock traders tend to ignore share structure, as do some company CEOs, but value investors avoid junior resource companies that have issued excessive numbers of shares relative to their known resources and stage of development.

Stock traders argue that the number of shares is irrelevant as long as the stock price rises. What they mean is this: consider hypothetical companies A and B where Company A has 50 million shares outstanding, versus Company B that has 150 million shares outstanding. Let's say, both have a market cap of \$10 million. If companies A and B achieve the same milestone, and an equal number of investors invest an additional \$10 million into each stock, Company A's shares move up \$0.20 while Company B's shares move up \$0.07. Company A's share price doubles from \$0.20 to \$0.40 and Company B's share price doubles from \$0.07 to \$0.14. Quantitatively, it makes no difference how many shares a company has issued, but there's more to it than that.

Although the mathematics are not in dispute, value investors will note that such calculations are simplistic, that they ignore all of the qualitative dimensions of a business and that they have no connection to the real-world value that ownership of a resource company's shares represents.

### SHARES OUTSTANDING

Micro-cap resource stocks, and Canadian junior mining companies in particular, are thinly traded. If a company has too many shares outstanding, the share price

does not necessarily move as the company progresses through its developmental milestones. In other words, supply and demand can prevent the share price from moving up if there's excess supply.

If the company needs to raise money, it may have to issue a very large number of shares and investors can be ratcheted down in terms of percent ownership as the company moves forward. Ideally, a company's share price would rise significantly as the company moves forward so that the company issues fewer shares in successive financings, rather than more.

### SHARES FULLY DILUTED

The number of shares fully diluted, including options and warrants, is also a factor when evaluating junior resource companies. The number of shares fully diluted can be anywhere from 5% to 25% of the number of shares outstanding. If options and warrants are exercised, the company will receive cash based on the strike price and the number of shares outstanding will increase. The ownership stake of some shareholders will decrease while that of investors exercising options or warrants will increase. If the number of shares fully diluted is unusually large, the risk of shareholder dilution for ordinary (outside, passive, minority) investors is higher.

Expiring warrants or options can result in selling activity, putting downward pressure on a company's stock price. If a particular stock's price has risen following a private placement, warrant or option holders may take profits. The exercise of large numbers of options or warrants can move the share price down as investors liquidate their holdings. Savvy investors who did not participate in a particular financing often wait to buy a stock until after warrants or options have expired, looking for a dip in the share price, but large num-

bers of warrants or options can backfire if the result is an excessive number of shares outstanding.

### INSIDER OWNERSHIP

Significant insider ownership is generally a positive consideration because the management is incentivized to make the business successful, but management incentives are insignificant compared to the quality and experience of the management team. Insider ownership can come about in different ways. Company founders may hold a significant percentage of the company as a result of having founded the business, or members of the management team may themselves be large investors. The best case is where senior management, e.g., the CEO, is a major investor, thus has proverbial skin in the game, and also has a track record of success in similar companies. Conversely, an inexperienced CEO or management team with a controlling interest in a company represents an additional risk.

### MAJOR SHAREHOLDERS

Major shareholders in a company, such as institutional investors, are a key indicator of quality and investment horizon. One way to approach major shareholders is to look at their other investments, track records and particular strategies. If a company's major shareholders have consistently picked winning companies, there could be a higher probability of success. The involvement of large companies with a strategic interest in a given resource, such as gold or rare earth elements (REEs), can be a validation of the company. Of course, every value investor should do their own fundamental research.

### RESOURCE VALUE PER SHARE

Otherwise similar companies, with similar

resources, are not directly comparable in terms of share price. Value investors should consider what resources each share of stock represents and whether the share price is reasonable on that basis.

One approach is to calculate the net resource value per share fully diluted (NRV) divided by the cash value of the company per share fully diluted ignoring the value of its resources (CVS). The NRV/CVS quotient is a simple way to filter companies into two buckets: (1) potentially overvalued and (2) potentially undervalued. Large NRV/CVS quotients, such as 500% or more, indicate that a company's total resources, less production costs, are worth more than its cash/debt adjusted market cap. Companies with high NRV/CVS quotients may have higher upside potential or may be takeover targets.

### CAPITAL INVESTMENT EFFICIENCY

The number of shares outstanding and fully diluted can be an important indicator of the quality of the company's management. The number of shares outstanding for a given company can be excessive based on its type, stage of development and years in business. Different types of companies have different capital requirements and require different amounts of time to achieve their objectives. Comparing a pre-production geothermal power company or an established oil and gas producer with a gold exploration company doesn't reveal anything, but that's not the case within a specific category, such as discovery stage gold miners.

If two, otherwise identical, companies have widely different numbers of shares outstanding, there could be several reasons, not all of them good. Consider hypothetical companies A and B again, it

is highly likely that Company B, because it has issued many more shares over time, has raised more money than Company A. Supposing that the companies are identical, except for the number of shares, several questions arise regarding Company B: What did the company do with the money it raised at the expense of shareholders whose ownership stake was diluted in successive financings? Did the company fail to achieve its past business objectives? Has the company changed its business plan? Did the company raise or spend more money than necessary? Due diligence requires knowing the reason why a particular company issued more shares than its comparables.

The number of shares outstanding, shares fully diluted, major shareholders, insider ownership, resource value per share and capital investment efficiency are windows into the souls of natural resource companies. While stock traders, who rely on technical analysis, generally ignore share structure, it is an important consideration for fundamental analysis and value-oriented investors. If quality and value are paramount, share structure cannot be ignored. ■

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## HOW TO CALCULATE CVS

To calculate the CVS, take the market cap of the company and adjust it for the company's cash and outstanding debt then divide by the number of shares fully diluted. The result is a number similar to enterprise value on a per share basis, except that warrants and options are included in the number of shares (shares fully diluted) and the only asset considered is cash. To calculate the NRV, use a conservative value for the company's resources and determine the production costs per unit of resource, e.g., per barrel of oil, megawatt of power, pound of copper, etc., then take the net value of the company's resources (as if the entire resource were produced at once) and divide by the number of shares fully diluted. Divide NRV by the CVS to get the quotient.

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