The Trouble with Two Birds in the Bush

Perspectives: November 21st, 2023

Ask any *customer* of a builder, renovator or software developer and they will, for the most part, speak of projects taking far longer and costing much more than they expected. Bear in mind said customer often conveniently forgets how much they added to the initial project scope. "*Oh, wouldn't it be so cool if we could also have a [insert nice to have]*"

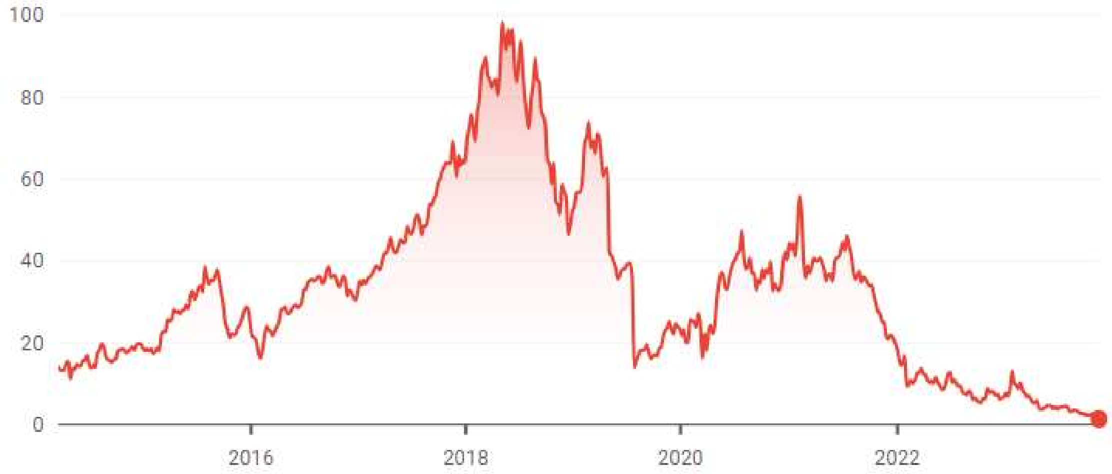
From time to time, we come across stock exchange listed companies with ambitious capital investment projects that are, or can quickly become, meaningfully underfunded. We are extremely cautious about investing in these. Capital investment projects can be or become underfunded in at least the following 5 ways that we can think of:

1. The most obvious one is whereby the company simply does not have the money available, right from the get-go. For example, JSE and ASX listed Orion Minerals do not even have a bankable feasibility study yet, let alone the massive investments required to build and operate a new mine.
2. Sometimes the company has funders seemingly lined up and ready to invest, who get cold feet and pull out leaving the project underfunded. An option to invest is clearly not the same thing as a legally enforceable commitment to invest. For example, JSE and ASX listed Renergen lost one of its apparent backers following a comprehensive due diligence by a deeply experienced global deal team.
3. Other times a company's profitability, free cash flows and balance sheet position deteriorates so badly and so quickly that their previously internally funded capital investment projects become underfunded. For example, JSE & US listed Sibanye Stillwater today announced a huge and dilutive convertible bond offering to try and raise funds for their capital investment projects. The reason they must raise funds in this way is because of rapid declines in the prices of the commodities they produce – a factor outside of management control.

4. Sometimes a company's projected capital investment project costs and timelines to completion can increase by so much that it puts enormous strain on the entire business, causing serious issues. For example, completing JSE listed Sasol's Lake Charles Chemicals Project eventually cost US$12,8bn in comparison to the envisaged US$8,1bn, and it took at least 3 years longer. Those were not small margins of error, and ultimately it brought the once mighty Sasol to near ruin if not for the last-minute distressed sale of a lucrative portion of the LCCP project at the absolute bottom of the cycle and the fast-paced cyclical recovery thereafter in oil and chemical prices.
5. In an interesting twist on this topic, sometimes companies such as the US listed online education group 2U just continue producing increasingly larger losses while simultaneously acquiring other companies. This went on for over 5 years, but in 2018 the jig was finally up and the market recognised that this emperor too was, in fact, stark naked.

Investing in companies with underfunded large-scale capital investment projects are tricky investment propositions - *even at the best of times*. If anything goes wrong they turn into outright disasters that result in deep and permanent losses for their equity shareholders. We always prefer investing in businesses where we can clearly see for ourselves that credible leaders are executing credible, and funded, plans – ideally with a number of safety valves just in case the malva pudding hits the garburator.

Chart: 2U Share Price 2014 – 2023 [*Source: Google Finance*]



Our work continues…

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