REAL DEAL BY CHRIS HINDE

MinesandMoney

One of the world's most influential economists has died but his work on asymmetrical information remains important in understanding mining transactions.

The work of Professor Sir James Mirrlees, who died at the end of August, was probably not high on the reading list of mining executives, but it should have been. Born in July 1936, Mirrlees graduated in mathematics at Edinburgh university and completed a PhD in economics at Cambridge. His work on information asymmetry, for which he won the Nobel Economics prize in 1996 (and was knighted the following year), was crucial in understanding the process of negotiating.

Actually, Mirrlees published what he considered his most important work 25 years earlier, when, with Peter Diamond, he produced a report that evaluated optimal tax rates. This centred on the link between levels of taxation and the motivation to work, and resulted in the Diamond-Mirrlees efficiency theorem. Three years later he published, with Ian Little, a study, 'Project appraisal and planning for developing countries'. This has been described as the bible for investing in emerging economies.

Nevertheless, it is for his work on information asymmetry that Mirrlees will be best remembered. This is where one party in a transaction knows more about the asset than the other party. For example, buyers, whether for houses or mining projects, are often acting with less knowledge of the asset than the seller. In particular, Mirrlees explored why buyers and sellers fail to secure all the information they need when making a purchase or sale.

World Bank concerns

Reference: [World Bank Report]

In a World Bank report in September 2003, Quy-Toan Do noted that “asymmetric information, as the adjective indicates, refers to situations in which some agent in a trade possesses information, while other agents involved in the same trade do not”. Recognizing that the presence of information asymmetries could be the source of large economic inefficiencies, the World Bank investigated the characterization of the mechanisms, or institutions, that could alleviate the information asymmetry.

Information asymmetry in the mining industry was the subject of a paper in the Journal of Applied Business and Economics in 2013 — vol. 15(3), pp56-67; ‘Junior Mining Sector Capital Raisings: The Effect of Information Asymmetry and Uncertainty Issues — by Casey Iddon and Samanthala Hettihewa of the University of Ballarat, Australia, and Christopher Wright of Burgundy School of Business, France.

Reference: Paper

The authors noted that the exploration sector is dominated by small firms who are vitally dependent on their capacity to raise external capital. However, as the report concluded, these junior companies are “beset with information asymmetry, and at times moral-hazard issues”, that drive “massive discounts in initial public offerings and secondary equity offerings”.

Insufficient funding

The fundamental issue explored in this paper was that while the junior companies can, potentially, generate spectacular future earnings, they are more likely to exhaust all their capital before generating these earnings. The uncertainty is so great as to leave little means to differentiate between future winners and losers. The researchers posed the question; how do juniors organize themselves in response to strategies used by investors to value their assets?

The researchers considered the role of reputation as a possible means of moderating the information asymmetries but found that “empirical evidence was mixed”. They also concluded that deep discounting of share issues was, at best, only marginally effective.

The analysis suggests that, given the great difficulties junior companies face in resolving information asymmetries, investors were often making a return that was “a mere fraction of the gain created by their investment”. This imbalance could be mitigated, the authors suggested, by implementing a significant increase in tenement fees whilst allowing exploration companies to deduct their bona fide prospecting costs from those fees.

Taken together, Mirrlees’ work on tax and motivation, his project-appraisal ‘bible’ for investing in emerging economies, and his exploration of the differential knowledge between buyers and sellers, made him one of the most important economists for the mining industry.

The need to narrow these information asymmetries is, of course, one of the reasons we should all attend meetings, seminars and conferences. Get out and about; the more data that we can share, the flatter will be the playing field for transactions.

Chris Hinde

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