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Letter to the Editor: M&A holding pattern to continue

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LAST week's article on merger and acquisition activity from Mines and Money London provoked this response from a reader.

In your article of December 3, 2014 "M&A holding pattern to continue", EY's lead partner Lee

Downham is correct in saying "capital discipline is now the order of the day". The only issue we would have with this is that capital discipline should have been the order of the day throughout the cycle. For it is return on capital employed (ROCE) that truly drives total shareholder returns (TSR).

Further, we agree that TSR is the reason for any public company's existence. That is, the delivery of
TSR should be the purpose of any company using other people's money. John Argenti framed this most eloquently more than 30 years ago in the Argenti Purpose Sequence, which proposes three questions that should precede any strategic planning exercise:

1. Who is the organisation set up to serve (beneficiaries)?
2. What benefits do those beneficiaries expect?
3. What level of performance would the intended beneficiaries deem satisfactory and what level would they deem unsatisfactory?

This last question is answered by the development of a beneficiary performance indicator (BPI) and for public companies it is indeed TSR.

Where we diverge from Downham's view, as reported, is that management cannot directly control TSR outcomes. Therefore, an internal measure of performance is required and ROCE should be the metric of choice in any capital intensive industry, such as mining. ROCE is under management's control and, most importantly, is the most potent driver of long run TSR performance. It is not profit or earnings per share (EPS) that deliver TSR, despite what many management teams so incentivised may think. ROCE needs to be the principal focus of management and it provides the accountability against which boards can determine appropriate allocations of capital. Directors and executives alike must know the company's weighted average cost of capital and deliver ROCE returns in the long run that exceed that cost of capital when making investment decisions on behalf of the intended beneficiaries, i.e. the shareholders.

Yours sincerely,
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