Blurring the cost of capital differences

Not distinguishing between the needs of investor classes is an unfortunate habit of many small miners

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Discount rates are seldom the subject of debate when companies express views about the value of their development proposals but important differences in the cost of capital sitting behind any discount rate can explain why some investors buy and others stay away.

In a typical feasibility study, discounting an unleveraged income stream with a weighted average cost of capital provides an estimate of project value. If the anticipated return on the capital invested exceeds the estimated cost of capital for the project, it stands a chance of getting financial backing. This is the conventional approach to discerning value in the mining industry.

An assessment of the equity value of a project, on the other hand, should use the cost of private equity as the discount rate. This discount rate should be applied to cash flows after debt costs or repayment of loans since the equity investor will only be entitled to the residual after all debt servicing obligations have been fulfilled.

For investors in listed equities, the value considerations will differ again. Their cost of capital will reflect alternative investment returns in the listed space because they must pay to buy a share of the company housing the asset. This is not a cost faced by an investor buying into the project directly.

Debt decision

A debt provider will have other considerations, including the source and cost of funding, in deciding the appropriate discount rate to be applied to a project. The size of the residual available for equity investors will be of lesser concern.

There is no single right or wrong discount rate. What is appropriate depends on the investor being addressed or the question being asked.

In the Australian market, an independent expert used a 15-16% range for the cost of equity in 2012 when assessing the value of Coal of Africa Ltd. In reviewing the Gloucester Coal acquisition in 2012, another expert concluded that the cost of equity was 13-15%. Another of Australia's leading independent valuation practitioners assessed the cost of equity as 10-11% in valuing the OZ Minerals businesses in 2009.

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Recently completed studies for the Kasbah Resources Ltd's Achmmach tin project in Morocco and the Elementos Ltd's Cleveland tin project in Australia both applied an 8% discount rate to unleveraged cash flows to derive project values, according to the companies' commentaries on the studies.

With the yield on 15-year Moroccan government debt at just under 6%, an additional two percentage points appears insufficient compensation for risk for an investor targeting Moroccan assets.

For investors with access to US dollar or Japanese Yen funds looking to take a preferred and secured position in a project, on the other hand, an 8% return might be more than adequate with funding costs likely to remain low for a protracted period. Similarly, a trader or smelter with a strategic need for new sources of raw materials might regard 8% as cheap.

Viewed as an Australian equity investment for a domestic portfolio, the appropriate rate-of-return target would have to take into account a 4% long-term government bond yield, an equity risk premium of up to another six percentage points, an additional sector risk premium and any company specific and geographic risks. Among these risks would be the development stage of the project and the absence of funding or customers at the moment.

After 10 years in which Australian large-cap industrial sector equity returns have averaged 16% a year and with yields on some of the world's least risky banks sitting around 5%, return expectations among Australian equity investors would be considerably higher than 8%, possibly by a factor of two.

The cost of capital for an investor in listed equities should be viewed as the risk adjusted return required to make an investment competitive against the alternatives in the market.

Since each investor is likely to have a different perception of the risks that might affect market outcomes, there is a theoretically infinite array of discount rates that could apply. They will also vary over time.

To sidestep the complexity of multiple discount rates and valuation ranges, most mining company presentations tap the data from project feasibility documents even when they are addressing investors in listed equities. They usually do not distinguish among the needs and objectives of different investor classes.

Convenience contributes to this habit. The choice is also biased because project returns using debt market capital costs appear more attractive than equity investment returns.

In practice, too, consultants and advisers are employed to model and value projects, not companies. In most instances, companies do not have the analytical backing to talk about anything other than their projects. They are usually ill-equipped to properly measure the impact of projects on corporate valuations.

Those companies adopting a one-size-fits-all approach to valuation are unthinkingly blurring some important differences in investment objectives among the debt providers, equity holders, regionally oriented investors, global institutions, retail investors and raw material traders they are targeting.

In the end, each of these groups will make their own assessments, set their own price targets and decide whether to invest. They might never confide to company management what their implied discount rates have been in coming to an investment decision, but each will have one.

Against this background, mining companies with a development offer are often left pondering why portfolio equity investors have proven reluctant to participate when others have come on board more enthusiastically. More often than not they blame investors for not appreciating the quality of projects.

The real answer might lie in the respective return targets different investment groups have used, even if only implicitly, in measuring the potential flow of income from the contemplated investments.

When properly measured against the cost of equity funds, many projects simply look far less enticing than companies have led themselves to believe through an erroneous application of inappropriate discount rates. ▼

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