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Valuation explanations need work

Ramelius Resources claims to be one of the most undervalued Australia-focused gold producers. It could be right, but for the wrong reasons.

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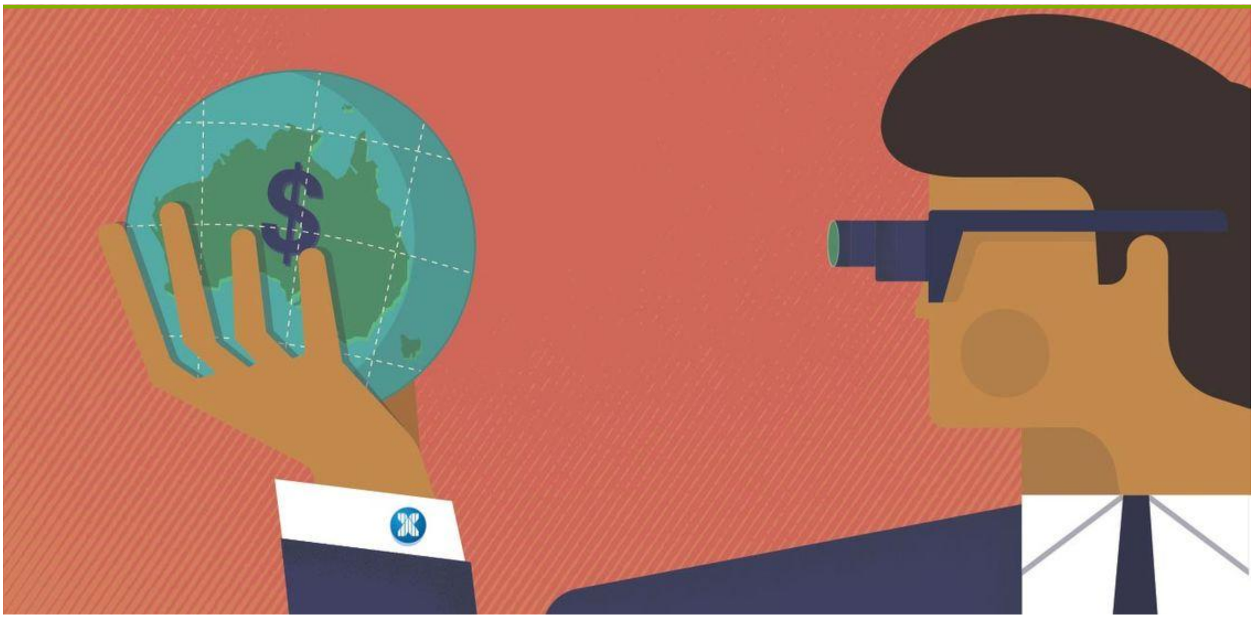

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In a recent presentation to investors, Ramelius chief executive Mark Zeptner described the company as significantly undervalued. Central to his argument was the company's ranking alongside 12 other companies based on enterprise value per ounce of expected gold production in 2018/2019.

At the head of the list was Northern Star Resources with a value around A$6,300 (US$4,511) per ounce of production. Evolution Mining was a tad under A$6,000. Another nine valuations ranged down to A$1,200. Then came Ramelius at just under A$1,000 followed by Blackham Resources, which trailed behind at close to A$800.

Investors were invited to conclude that the Ramelius value could appreciate sixfold and still remain within the bounds of what is typically being paid for a company with its production attributes.

The presentation of valuation data in this fashion is visually attractive, at first glance, and not uncommon but less analytically compelling after a closer look.

The Ramelius approach asks us to believe that the valuation metric at a point in time applying to the 900,000 annual ounces of Northern Star should set the benchmark for all others in the future, irrespective of size.

If this was an accurate description of the way in which gold mining assets were priced, the market capitalisation of Blackham Resources would be closer to A$600 million than its current A$60 million and Blackham would easily be the most attractive investment from among the identified companies. The market is far more complicated.

If all the companies, Ramelius excepted, were valued at A$6,000/oz for example, it would be reasonable to infer that Ramelius was disadvantaged by a temporary pricing aberration and that it, too, would be accorded the same valuation as other companies in due course. The investment proposition - based on a high likelihood of the gap being closed - would be clear.

> **Weightings vary over time as investors reconsider what they regard as important or react to changing investment climates**

In reality, the valuations are widely distributed with no duplicates. Quite clearly, and contrary to the impression conveyed by Zeptner, this is not the metric being used by the market to price gold producers, however frequently it might be cited in sector research as a descriptive measure.

The second aspect of the Ramelius proposition - that the 13-company average approximating A$3,200 should be a guide to valuation - is equally fallacious.

An average can be calculated for any numerical series without necessarily conveying any meaningful information. The average house number on the street on which I live is 180 but that does not say anything about the address a resident is most likely to occupy.

The average of gold company enterprise values simply says that some companies are above and some are below that number. There is no rationale - wishful thinking aside - to underpin a belief that companies will converge on the average.

The third feature of the Ramelius analysis that points to its limitations as a predictive tool is that any perceived discrepancies in value can be resolved in more than one way. If Ramelius is one sixth of the price of Northern Star, why should Ramelius have to adjust and not Northern Star, again putting wishful thinking aside?

Implicitly, in the Ramelius analysis, market capitalisation is a function of only two variables, namely, near-term production and cash holdings.

A strong correlation between market value and production does exist but other influences, including balance-sheet risk, explain critical variations from a sometimes only very broad trend. As a result, the relationship between production and market value is nonlinear.

Mine life, for a start, must be important. Whatever the current production, no-one expects to pay the same for one year's production as for multiple decades of the same output.

In practice, an ounce of gold production is valued differently, and permanently, in companies of different sizes. The companies with the largest production and resource bases gain attention from a wider range of investors, including those managing institutional portfolios, and attract premium pricing.

The two biggest producers - Northern Star and Evolution - are paid more for an ounce of production after having expanded their output aggressively through a combination of discovery and asset acquisition, knowing they could add to the value attributable to their pre-existing production by bulking up.

Statistical analysis suggests a production threshold of 250,000-300,000oz beyond which an ounce of gold is given a higher value than an ounce in a company with a smaller production base.

Costs of production, the growth trajectory and ongoing capital needs are additional measurable variables, putting aside less easily quantifiable indicators like operational skills and jurisdictional risks.

While it is tempting to simplistically latch onto a single measure of value that purports to offer a convenient conclusion, a more complicated weighting of factors is needed to reflect the reality of the valuation problem.

Even a complete marshalling of relevant influences might be overly simplistic since the weighting accorded to the various factors affecting value does not remain static. Weightings vary over time as investors reconsider what they regard as important or react to changing investment climates.

Current production might occasionally be of pre-eminent importance in dictating market prices but growth could be given a higher or lower weighting from time to time and, if gold prices are at risk of falling, production costs may assume importance in setting prospective returns.

A relatively simple statistical model relating market price to production and net cash positions, with recognition for a size threshold suggests Gascoyne Resources and Blackham Resources were the two most overvalued stocks in the group selected by Ramelius. Also defying the rankings, the two most undervalued were Ramelius itself and Westgold.

The Ramelius analytical approach happens to work to its advantage for the time being but highlights a re-rating potential more through accident than solid empirical evidence.

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