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Neither independent nor expert

Independent expert reports may contain fundamental flaws that render them ineffective as decision-making tools for investors.

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In July 2016, an independent expert used a value of A$26.5-34.1 million (US$20-25.6 million) for the Namakera vermiculate mining property in Uganda in framing a transaction opinion, as I noted in my April 12 column this year concerning the unfortunate history of Black Mountain Resources.

The report itself warrants some additional comments because the asset, valued in another report at A$1.5-2.3 million in 2013, had already passed through several hands without positive cash flow.

Moreover, since the report was published, Black Mountain duplicated the experience of the two previous owners of the profitless African industrial minerals property.

So, how could a business that has never shown any sign of profitability be assigned so much worth?

Part of the answer to this question is a bias in the structure of reports covering smaller miners with hard-to-value assets.

As in the Namakera instance, the designated independent expert usually hands over the valuation task to an industry consultant with greater geological or engineering knowhow.

By definition, industry consultants are a part of the mining industry. They rely on mining companies for the bulk of their income and depend on maintenance of

industry asset values for their business continuity.

With all their commercial eggs in the same basket as the egg on which their opinion is sought, a negative view is unlikely and unbiased judgement improbable.

Sometimes, the connection verges on the explicitly conflicted. The same independent expert responsible for the Namakera valuation published an opinion in June 2017 for Kula Gold on the value of the Woodlark gold mine in Papua New Guinea. He used a valuation report from a consultant with a prior and ongoing commercial relationship with the property owner.

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Taking the bias one step further, the consultant completing the Namakera valuation chose a methodology which could only produce a positive asset value, eschewing use of discounted cash flow valuation methods, despite several years of operational history.

The valuer multiplied the quantity of material contained in the resource (discounted by 50%) by an estimate of the prevailing price (discounted by 90%). The discounts, unsupported analytically, appeared dramatic but were actually prone to exaggerate the value proposition.

Deriving the same valuation from discounting future cash flows would have necessitated annual positive cash flows of A$6-7 million over 20 years. At full plant capacity utilisation, which had never been achieved, such cash flows would imply margins of around 70%. There was not a skerrick of analysis - prospective or historical - to support this possibility.

The consultant produced a similarly exaggerated valuation for the residual assets of Black Mountain. Even then, the independent expert concluded that the net worth of the erstwhile North American silver miner was zero.

Despite the wildly optimistic view implied about what a willing buyer and a seller were likely to agree - the standard the valuer is mandated to adopt - the parties to the transaction knew better.

Tempered by real world experience, the seller of Namakera was willing to take worthless paper from the only interested buyer in the hope of being able to conjure something from his own near-hopeless situation.

Independent experts find themselves shackled to their subcontracted technical experts even when they might have doubts about their conclusions.

In the Kula Gold report, the industry valuer adopted a discounted cash flow approach to put a value of US$45-95 million on the Woodlark mine despite there being no operating history and while costs and development plans described in a 2012 feasibility study were being revised because they had never been able to justify an investment proceeding.

The independent expert observed that "[t]he Woodlark gold project may enter production some time over the next few years but this cannot be assured or guaranteed".

Neither the capitalisation of future earnings nor discounted cash flow methods of valuation were appropriate, the expert concluded, because of "the lack of profit history arising from business undertakings and the lack of a reliable future cash flow from a current business activity".

Despite the difference of opinion and his own warning, the expert felt obliged to adopt the discounted cash flow valuation range proffered by the technical consultant without any adjustment for

development-stage risk.

Valuers too often assume unquestioningly the presence of funding, relevant skills and market access. In doing so, valuations are based on an assumption - against all experience for early-stage untested companies - that development objectives will be achieved in a timely fashion.

The Namakera project was doomed to fail without a US$5 million capital injection. The technical consultant never tested whether Black Mountain could meet this funding need.

Similarly, independent experts and their consultants rarely examine critically the skill base, exemplified through a track record, of those claiming to complete a development.

Nor do valuers always assess whether a company has ready markets for any output. Among the problems faced by the Namakera project over the years, and ignored as a potential influence on the valuation, was its inability to penetrate markets by enough to validate full capacity utilisation of its plant.

The Namakera project might have been able to realise a value of A$30 million or more if funding, skill and markets were all in place but they were not. Knowing what could happen in an inaccessible parallel universe even Stephen Hawking might have found hard to imagine is not especially worthwhile.

A hundred pages of neatly summarised data with multiple appendices may still run contrary to "how an expert can help security holders make informed decisions about transactions", the Australian corporate regulator's view of the role of independent expert reports.

Focussing on the consequences of success at the expense of what is actually going to happen edges so-called independent expert reports toward being useless as an investment decision-making tool, whether or not they adhere to the letter of the law.

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