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Three routes to mining value

Sandfire Resources, Asiamet Resources and Emmerson Resources offer three contrasting approaches in the search for value in an industry unsure about the best model for delivering investment returns.

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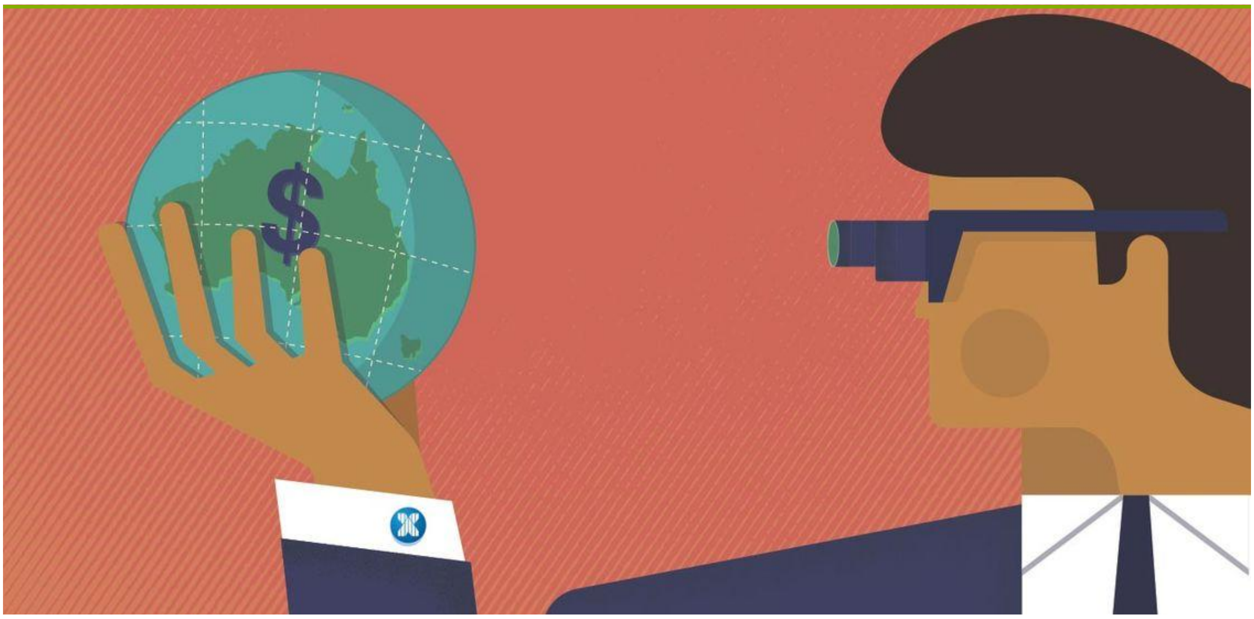

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In theory, the value proposition behind a mining investment is straightforward. As long as the return on capital invested exceeds the cost of funding, shareholders should benefit.

In reality, directors struggle to even define what they mean by value, often leaving shareholders to guess how they will profit from a mine development. The uncertainty encourages a focus on news flow or near term commodity price movements.

Sandfire Resources remains one of the most successful mining ventures in the recent history of the Australian industry. With an investment of A$747 million, the company has generated net operating cash flows of A$1,395 million over eight years.

By the end of 2019, shareholders had received A$164 million through dividends and lenders were repaid A$380 million. The company retained growing cash assets of A$202 million.

The company's flagship operations in Western Australia have sufficient reserves for another three years of production. Cash holdings could near the company's $825 million market capitalisation at current metal prices and operating conditions.

Directors have been using the accumulating financial firepower to buy new assets and build new mines.

With mining scale being due as much to accident as design, future investment appeal is no foregone conclusion, however impressive the Sandfire history.

Even if the company is resoundingly successful in new ventures in Botswana and Montana, each new mine comes with fresh risk and postponed cash flow distributions with an adverse impact on value. Market returns are also tougher to achieve.

Sandfire would need a market capitalisation in six years of around A$1,800 million for an investor with a required return of 14%. If the company is valued on the same basis in 2025 as it is today, it would need annual copper production well over 100,000 tonnes, compared with around 70,000 tonnes in 2020. Even then, Sandfire will have been well past its best days as an investment.

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Higher copper prices would boost earnings and deliver better investment outcomes but that would not benefit Sandfire alone. Any number of companies will have greater leverage to improved market conditions.

AIM-listed Asiamet Resources is seeking to develop the BKM copper resource in central Kalimantan. A June 2019 feasibility study outlined a plan to produce 25,000 tonnes a year of copper cathode for nine years. An initial capital outlay of US$223 million would produce pre-tax cash flows of US$563 million suggesting a return to equity investors equivalent to a bond yield of 17%.

With a similar valuation to Sandfire, Asiamet could push its current market capitalisation of just under US$50 million to about $190 million over five or six years.

On the upside, the company believes it can quickly add several years to the mine life from exploration targets around the proposed mine development. On the other side of the ledger, the current copper price of around US$2.45/lb is below the US$3.30/lb price assumed in the feasibility study. The difference could reduce project cash flows by over $320 million.

To support his investment case, company chairman Tony Manini has argued that copper demand will continue to grow at a steady 2.5% resulting in an ongoing metal deficit.

Unfortunately, his numbers are out of date. Copper use has grown by less than 2.5% in four of the past five years, according to the International Copper Study Group. The downward pressures on demand will have only worsened in the aftermath of the coronavirus pandemic.

Previously anticipated market deficits are less likely. Tight market balances will now depend on supply side controls which rarely excite investors as much as cyclically strong demand.

Asiamet will have to negotiate the stereotypical industry development trap in which thinly capitalised companies are marooned in the commercial no man's land between resource definition and mine construction.

Manini says he is negotiating with Singapore-based Aeturnum Energy for the sale of the contract of work which includes the BKM property. Such a move gets shareholders out of a potential bind and gives them the chance, if there is cash on the table, to try again with greater security with one of the company's other development assets.

Shareholders are generally displeased when they end up with minor project interests having been enticed with promises of big mines. To his credit, Manini had braced himself for a dearth of buying interest and has primed investors to expect a partner for the project.

Taking the best price available and moving on to the next opportunity does investors a favour even if they are disappointed by the outcome. The bird in the hand argument should not be ignored.

Emmerson Resources is following a third way forward. Addressing investors in an online briefing recently, chief executive Rob Bills spoke of discovery, not development, as generating the most value.

Bills' prize exploration assets are in the region of New South Wales, home to the recent Alkane resources copper-gold discovery and Newcrest Mining's Cadia-Ridgeway deposits. Emmerson has identified relatively shallow copper-gold targets with similar attributes to the existing finds.

In some respects, Emmerson resembles any number of other exploration companies with high hopes but tight budgets. Its distinguishing feature is what Bills describes as "absolutely phenomenal" royalty streams from Tennant Creek gold properties due to start production in 2020 and which can fund the company's copper discovery endeavours.

From an investment return standout, Sandfire faces the toughest challenges. That will not stop it being a destination for funds more concerned about tracking an index than finding extraordinary investments. It will remain a role model for other companies.

An emphasis on extracting value from discovery probably limits the Emmerson size potential and its universe of potential investors. If size is important, Sandfire is the choice. Market returns, on the other hand, are likely to be highest for Emmerson and, to a lesser extent, Asiamet if they can execute efficiently.

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