MiningJournal

What could possibly go wrong?

Forward looking statements will remain a regulatory bugbear as long as neither regulators nor companies are willing to give investors the information they need.

John Robertson* | 03 Nov 2016 | 9:08 | Opinion

The bio-tech industry has a reputation that affords it more flexibility with its forward-looking statements

Any investment decision rests on four legs: how much capital must be put at risk: how much will be returned; how long will it take; and, finally, how likely are these pre-investment estimates to be right?

Without answers to these four questions, a reasoned decision cannot be made.

The same questions apply to buying a rental apartment down the street, making a loan to a friend or building a wind farm in Uzbekistan. The complexity of the accompanying analysis might differ but the underlying framework to measure the value proposition will be identical.

These are the questions to which mining companies must also respond to adequately inform investors.

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In October, Australia's corporate regulator reissued its guidance note (INFO 214) on forward-looking statements in the mining industry to clarify what it would allow Australia-listed companies to say about their future production intentions. The redraft comes after an earlier version of the document issued in April was widely panned by the industry.

In short, ASIC has reaffirmed the need for companies to show what it sometimes ambiguously refers to as "reasonable grounds" for claims about future operational or financial outcomes.

Mining companies are not alone in having to attract investors without a sales track record to demonstrate potential returns.

Companies attempting to prove the potential of a new drug or medical device have similar risk profiles to companies developing mining properties.

In trying to guide investor expectations, biotech companies will commonly say something along the following lines: "$5 billion is being spent by health care providers on competing therapies presently. If our new treatment can take just 5% of this market, the company's revenues would be $250 million, justifying a market value well beyond the current $10 million."

"The missing ingredient is an understanding of the risk profile"

This widely used form of words begs an obvious question, namely, what is the chance of grabbing 5% of that market segment.

With less reputational bad odour with which to contend, the more highly-regarded biotech sector has not been under the same pressure to show reasonable grounds for claims about levels of market penetration but, to their credit, biotech companies are more prepared to speak about risk explicitly.

Independent analysts have also assessed the likelihood of a drug successfully moving through the various stages of clinical trial needed for eventual approval. The likely efficacy of drugs becomes a matter of record as trials proceed. Global valuation and transaction comparisons abound.

Much of the discussion in biotech investment forums is about the risks affecting product adoption and the consequent impact on company valuation.

The mining industry, on the other hand, appears hell bent on denying risk.

Companies are prone to making unrealistically dogmatic claims about intended outcomes. Anticipated production targets, cash flows and valuations are reported with spurious degrees of accuracy. Allowances for capital and operating cost variations built into feasibility analysis methodologies are never reflected in the point valuations for projects released to investors.

Nor do companies admit to any negative impact on their capital structures when releasing feasibility studies despite ASIC saying that "it will also be appropriate to warn investors if this requirement for project finance is likely to result in a dilution of the value of their existing shares".

Companies habitually refer to projects as "compelling" or "robust" when they might better be described even at the most-advanced stages as uncertain and risky.

To counter the tendency toward risk denial in the industry, mining investment regulators are prodding companies to bulk up evidence in support of forecasts. They have always been required to do so but many have succumbed to the temptation to cut corners.

The regulator's approach seems to recognise the information shortcomings but erroneously assumes risk can be eliminated or at least made irrelevant to an investment decision.

An alternative approach would let companies make forecasts of their choosing but, at the same time, require them to explicitly attach a probability to the key steps toward foreshadowed outcomes.

The regulator would no longer police the claim but focus on the rigour of the risk assessment.

A miner could say, for example, that it is going to spend $100 million to produce 100,000 ounces of gold a year for 10 years at a cost of $1,000/oz.

Since this would give investors only three of the four legs needed to make a sound judgment about the potential value of a contemplated investment, disclosure would remain inadequate.

The missing ingredient is an understanding of the risk profile.

What is the chance of raising the necessary funds to complete development? What is the chance of meeting the production target? How likely is it for these aims to be fulfilled within the intended timeframe?

The current ASIC approach plays into the hands of the industry by agreeing with it that these risks should not be addressed explicitly let alone quantified.

In downgrading the needs of investors, the tug of war between companies and regulators has dragged the debate about desirable disclosure practices onto more favourable grounds for those in the industry seeking to downplay its risk characteristics.

ASIC is putting up some modest boundaries around these risk-denial tendencies but the industry has defined the ground on which these markers are being placed.

Miners would certainly complain about how difficult, and possibly embarrassing, it might be to put risk frameworks in place publicly.

Their complaints should not be of great concern. One should worry about industry governance standards if these matters are not being explicitly addressed in boardrooms already, even if not discussed publicly.

In any event, probabilistic assessments of discovery and development potential are well established in the oil and gas segment of the resources industry as well as in health sciences. Workable models already exist.

There is no excuse for the miners failing to adopt similar standards.

John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia