Opinion

FROM THE CAPITAL

Timing key in Orbis fight

Orbis Gold directors reject SEMAFO approach, but for how long?

John Robertson*

Orbis Gold can produce US$873 million in cash over the coming nine years while spending US$234 million to develop a gold mine in Burkina Faso, according to its directors. SEMAFO, a Canadian-listed miner, is prepared to pay A$162 million (US$138 million) now for the future net return of US$639 million. Orbis directors believe SEMAFO is being unreasonably stingy. They claim the price is not fair.

As with any takeover, fairness is unlikely to have been a primary motivation. SEMAFO directors will know they do not have to compensate Orbis shareholders for future benefits that might come with mine development.

Nor do they have to accept valuations that rely on higher gold prices. They just have to pay today's market price for assets at a comparable stage of development.

Orbis could be worth several times its current market value in years to come. A takeover is a test of how strongly the directors of the target company believe they can capture this future upside and how convincing they are when they try to persuade their shareholders.

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Orbis directors will most likely get cold feet if they have to rely on a future improvement in market conditions to justify staying the distance. Even the prospect of value created by successful development of a mine in the future might not be enough to steel their nerve against a corporate assailant.

This is not singling Orbis directors out unfairly. History is clear. Appetite for a fight fragments quickly when the choice is between today's certainty and a more nebulous outcome that depends on future favourable markets and operating success.

The balance of power usually favours a well-funded acquirer. In its favour, SEMAFO has foreshadowed a cash bid rather than a scrip offer. Orbis directors might reasonably try to eke out a few dollars more but the die will almost certainly have been cast if the bid price is consistent with current market conditions.

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On the other hand, if the SEMAFO offer price is out of line with the current market, Orbis directors should come out swinging in defence of their shareholders. They would have an obligation to do so.

Mother Nature often conspires against easy comparisons of asset values in these situations, although in this case there are some clear similarities that might help Orbis directors build their case. SEMAFO, like Orbis, is a Burkina Faso focused miner.

Orbis has foreshadowed average production of 218,000oz a year, which is almost identical to the production guidance of SEMAFO for 2014. SEMAFO is expecting cash costs this year of up to C$675/oz (US$594/oz). Orbis puts its prospective cash operating costs at US$534/oz.

The temptation to apply the SEMAFO C$1,040 million market value to Orbis discounted to take account of the timing of mine development would be too simplistic. SEMAFO is in its sixth year of production at its Mana mine in Burkina Faso. Orbis has yet to produce an ounce of gold. Track record and credibility have value.

Sustainability is also an issue. On November 19, Orbis managing director Peter Spiers, speaking in Melbourne, outlined a development plan that involves producing at an average annual rate of 218,000oz of gold, but with 412,000oz in the first year.

The Orbis plan has mine output falling after a big first year start to as little as 132,000oz in year five.

Higher near-term production comes at the expense of lower production later.

Cash flows are potentially brought forward and capital pay back periods are cut, but the opening production rate cannot be sustained.

Markets are most generous when they have an income flow that is readily reproducible.

Near-term cash flows can be capitalised on the assumption that they will be ongoing. Orbis does not offer this option.

The bunching of production under the most recently unveiled plan also leaves the company relying disproportionately on the market conditions prevailing over the first year of production when over one quarter of its output is scheduled to be sold.

Most likely, arguments over price will rest on which project characteristics should be given more or less weight in judging whether the bid is consistent with how the market is pricing assets in the industry.

To help judge relative value, EIM Capital Managers uses a statistical model to measure how much weight the market is placing on the key drivers of value in the gold sector at any point in time. Weightings are inferred from the market rather than subjectively imposed.

By bringing the main value contributors together in this way, the model can estimate an average value attributed by the market to any given set of project characteristics at a point in time.

At the time of writing, according to the model, Orbis could expect to have a value of US$250-US$300 million if it was already producing in line with its most recent business plan. This is based on the way the market is presently pricing other stocks. Next week, the value might differ again.

Since it is not producing, today's Orbis value is considerably lower. In fact, the modelling framework suggests the foreshadowed bid price of $162 million is at or only slightly above the market average for a comparable asset.

That limits the scope for Orbis directors to argue that SEMAFO is not paying enough.

But, of course, those market-based values reflect what a portfolio investor is prepared to pay currently and do not take account of the benefit to an acquirer from having full control of the company and its cash flows. No doubt Orbis will make this point to its optimistic suitor when it tries to extract a more generous offer.