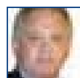
# The value of cash

## Markets take direction from evidence before good intentions



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Bauxite Resources Ltd is just one company with a common gripe: its share price is less than its cash backing. Implicit in the corporate lament is some sort of market failure to value cash appropriately.

Of the 1,000 or so listed resources companies in Australia, EIM Capital Managers has identified 68 with cash positions at the end of their last reporting period in excess of the market value of their equity. Another 22 had cash positions within 85% of their market values.

Bauxite Resources, a A$30 million (US$26 million) company with a net cash position of A$43 million, is looking to develop bauxite deposits in the southwest of Western Australia. Its extensive 14,266sq km tenement holdings sit immediately adjacent to those of Alcoa Inc and BHP Billiton in the world's largest bauxite producing region. Presenting to investors in December, chief executive Peter Canterbury outlined a plan to begin shipping bauxite to China before building an alumina refinery.

The company is well positioned for port access with options at Kwinana, Bunbury and Albany. It has joint ventures in place with China's Yankuang Resources, which also has coal mining interests in the region.

In 2010, under departed executives, the company faced allegations it had misled investors during a share placement that raised A$57 million. No action was ever launched, but the possibility of a class action has not gone away – adding a special twist for investors trying to value its cash balances.

More generally, a dollar in a company's bank account is never worth the same as a dollar in the pocket of an investor. Once the company gains control of funds, investors' choices are limited, if not eliminated. The only question is by how much the value of the cash should be discounted to take account of the loss of control.

Theoretically, a company could return any unused cash to shareholders until a need arose. Against all the evidence, most analysts implicitly assume this will happen in their valuation models, leading to sometimes impossible price expectations in which putative value always exceeds cash holdings. There is some evidence to suggest a discount of as much as 40% is a more realistic reflection of the way markets price cash stuck in corporate treasuries.

*Bauxite Resources' drilling in Western Australia*

A cash position can reasonably exceed the market value of a company if future expenditure is likely to greatly outstrip current financial resources. In the case of Bauxite Resources, a move to build an alumina refinery – possibly costing as much as A$4 billion – would dwarf any currently available cash.

In other cases, there is uncertainty over companies having enough cash to cover even modest but higher-risk exploration efforts. Overland Resources Ltd, for example, had cash of A$2 million with a market value of A$1.9 million. However, it needs to spend a minimum of US$5 million to meet its obligations to acquire a 90% interest in an unproven Colombian gold prospect.

Philippines copper mine developer Indophil Resouces NL has cash in excess of A$200 million, A$20 million more than its market capitalisation, but development of the Tampakan copper-gold project has been stalled by a review of its economics and, more recently, Glencore Xstrata plc flagging it wants to quit the project. Indophil has lost control over when, and perhaps how, its cash is spent.

With a market capitalisation of A$42 million, Millennium Minerals Ltd is trading at just 1.5 times the 2013 EBITDA reported this month despite a mine life at its gold properties around Nullagine in Western Australia of up to seven years. With the prospect of higher production over the next two years and possibly lower costs, Millennium is seeking to at least replicate the 2013 result. The investment market is expressing considerable scepticism about whether investors will ever see the benefits.

The gold price could fall. The extent to which this is a worry for investors will depend, in part, on the cost structure of the company. Millennium produced its gold at an all-in cost of A$1,271/oz in the December quarter. The extent of the discount being applied to future cash flows would be lessened considerably if an outcome closer to the budgeted cost of A$789/oz had given investors a thicker cushion to protect against the possibility of a weakening gold market.

Debt is also a source of risk when gold prices threaten to fall below production costs. Millennium has to repay some A$31 million in outstanding debt, which it is doing as a priority having already repaid about one third of the borrowings used to fund the Nullagine project. This suggests scope for a significant fall in the future discount rate applying to Millennium cash.

A lower gold price implies the need for some reappraisal of the resource base and, with that, some possibility that the production rate or duration of production will be cut. Millennium has flagged that it will do this over the coming month with guidance on future production levels due in February.

Uncertainty about how future cash flows will be used could be the source of the most significant discount being applied to cash values. The standard model in the Australian mining industry is for companies to start looking for the next big thing before the first cash from existing projects has been generated.

Usually, funds that might have otherwise gone to shareholders are used for exploration and lost forever. Following even the most successful exploration or acquisition efforts, any payback to investors would be delayed, giving cause for an adverse value adjustment, at least in the short term.

The likely use of funds is one reason markets discount prospective cash flows so aggressively. Analysts' valuation models treat cash as though it was pocketed by shareholders the moment any product is sold. Markets, more sensibly, take a realistic view about what will happen to the cash until there is evidence of something better. ▼

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