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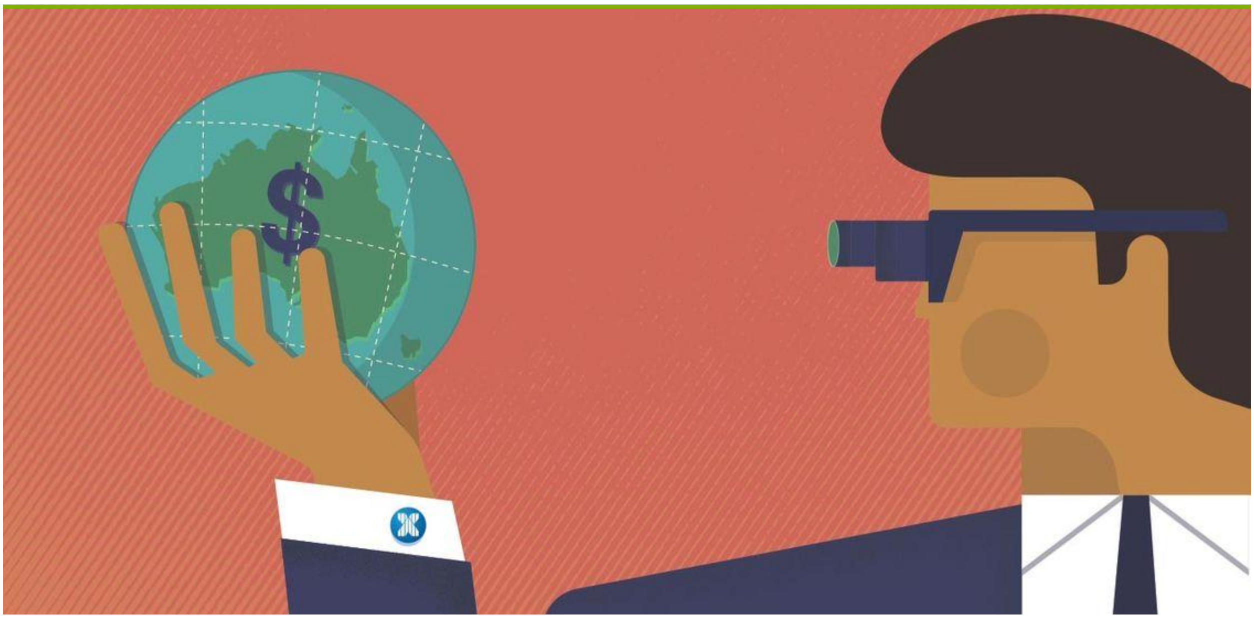
New rules needed for project values

Cardinal Resources has provided another glimpse into why market regulators should either ban use of project values or force companies to follow some basic rules.

John Robertson*



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Cardinal Resources released a summary of a feasibility study for its Namdini gold project in Ghana on 28 October. The study describes a 5.1 million ounce reserve underpinning production of 4.2 million ounces of gold over 15 years. An upfront capital investment of US$390 million is foreshadowed. Sustaining capital of US$182 million is expected to contribute $43/oz to all-in sustaining costs of US$895/oz.

An investment in Cardinal at the end of October when the gold price was around US$1500/oz would have been equivalent to buying a 17-year bond with a yield of 15%, if cash from the project was fully distributed.

Whether Namdini warrants being labelled a tier one project or whether its economics are robust and compelling, as claimed, is hard to discern in the absence of any generally accepted benchmarks against which to judge those terms, despite their popular use within the industry.

Cardinal directors, in line with industry practice, also placed a US$590 million value on the project to underline its attractiveness to investors in a company with a US$128 million market capitalisation.

Cardinal directors have highlighted a single point valuation despite acknowledging that the feasibility study has achieved an overall accuracy of ±15%. Single point valuations are simply inconsistent with the claimed accuracy in such project studies.

The company's pre-production capital spending estimate falls within a US$370-485 million range, according to its disclosures. Processing costs have been estimated to within ±15%, a US$131/oz spread from low to high. Disclosures within the feasibility document imply a project valuation range of US$260-870 million, assuming nothing else changes.

While resource estimates, capital commitments and operating cost expectations underpinning valuations are usually well-grounded empirically, selected discount rates come with more dubious pedigrees. Discount rates are typically unattributed to any legitimate source and their credibility unpoliced by regulators. The ASX pretence of asking companies to describe "the source and confidence" of the discount rate used to produce a net present value is universally ignored.

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Cardinal directors have based their ungeared project valuation on a 5% discount rate. In the summary document filed with ASX, directors say the 5% assumption covers market risk, technical risk and political risk. The selected discount rate is "appropriate to the specific project", they say.

Even in an era of historically cheap money, a 5% cost of equity tests credulity. Professor Aswath Damodaran at the Stern School of Business at New York University has published risk premia based on financial market asset prices for 95 industries and 160 countries. According to Damodaran, Ghana should attract a 7.3 percentage point equity risk premium. His estimated cost of equity for a North American precious metal producer is 8.8%. Objective financial market data suggest a discount rate pushing into double digits is warranted.

Cardinal, being an Australian company with a Canadian listing and a Ghanaian income stream, should have a blended cost of equity but that is not 5%. The valuation difference between a 5% discount rate and a 15% rate is a not insignificant $400 million for the Namdini project.

Authors of feasibility studies may need to rethink whether the discount rate is intended to measure the cost of equity or the marginal cost of anticipated project debt or a weighted average and make that explicit before offering a rationale for the selection.

After Cardinal chief executive Archie Koimtsidis spoke to a large gathering of investors in Melbourne recently, I asked him why he had chosen the 5% discount rate. He offered three reasons. His borrowing costs were lower than 5%, he said. Secondly, investors have different views so it does not matter what number he chooses. Thirdly, and in any event, he had merely used the same number as other companies.

In other words, debt and equity costs were conflated in a way that is not explained and there was no specific project link to the choice, despite the statement to the contrary in the ASX filing. The selected discount rate was simply a handy working assumption.

Another Cardinal director said that he was not prepared to discuss anything about the company's cost of capital but volunteered that, in general, a zero cost of equity would be an appropriate working assumption. He suggested I do my own analysis if I thought otherwise.

ASX listed companies usually do not provide sufficient detail in their feasibility studies for investors to independently replicate annual project cash flows, in contrast to Canadian listed companies. An NI 43-101 report in the next month or so from the dual listed Cardinal Resources will show the extent to which ASX investors are informationally disadvantaged.

In practice, project valuations are little more than window dressing. Highly biased company-prepared valuations are heavily discounted by equity investors as decision making tools. Their absence would be no great loss to investment decision making.

In a regulatory setting, bad practices quickly become culturally embedded, if tolerated, and sap credibility. Market regulators should move on four fronts to reinforce the credibility of valuations, if they are to be permitted.

Firstly, only valuation ranges should be allowed in public disclosures, consistent with the information derived from feasibility studies which offer the most detailed and complete analysis of a project available. Inevitably misleading point estimates should never be acceptable.

Secondly, consistent with currently unenforced listing rule requirements, companies should be told to cite objective financial market criteria in support of their discount rate selections, tailored to the specifics of a project.

Thirdly, companies should advise investors when changed market circumstances, including material moves in financial market conditions, have rendered invalid earlier discount rate assumptions.

Fourthly, once funding arrangements are locked in, companies should cease using any previously published valuations which rely on out of date assumptions about funding costs.

**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*