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Flawed valuations send wrong signals

Gold mine valuations can vary greatly depending on the chosen method.

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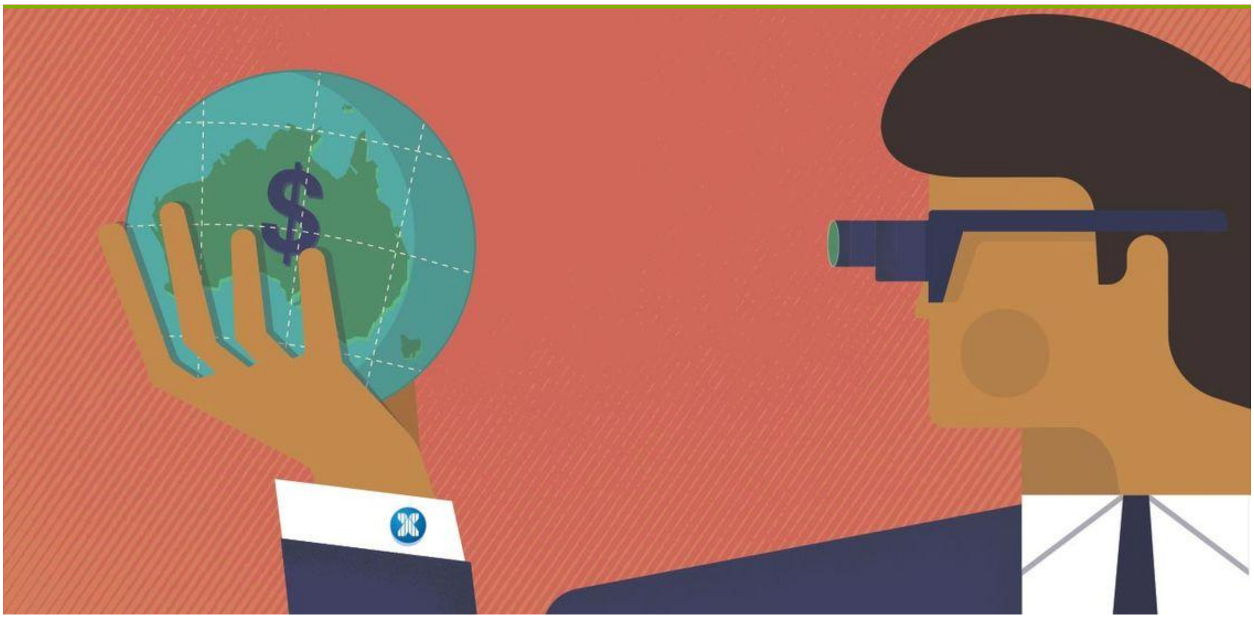

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Matador Mining has a gold project in Newfoundland which directors valued at A$194 million in a scoping study completed in May. A gold price of US$1,550/oz underpinned the study valuation. At a gold price of US$1,800, the after tax valuation would be closer to A$305 million or well over seven times the current market capitalisation of the company.

New chairman Ian Murray, former chief executive of Gold Road Resources, was adamant in a recent investor briefing that the company is undervalued. He is hardly unique as a company leader in questioning market conclusions about value.

While investors are commonly criticised for their failure to recognise value, erroneously selected valuation methodologies are seldomly blamed for the disparity in judgements.

The rock-solid consensus requiring use of discounted cash flow valuations ignores three flaws in the way they are used by gold companies.

Firstly, the discounted cash flow modelling in feasibility studies assumes that plans are successfully implemented. The resulting valuation points to how much should be paid for perfection. Since perfection is so rarely achieved, it makes no sense to pay for it.

Secondly, companies usually choose a single gold price assumption for their valuations. Volatility, a distinguishing feature of commodity markets, is unrealistically ignored.

The connection between what investors are prepared to pay for an asset and gold price movements is not as straightforward as discounted cash flow analysis suggests. After gold prices have risen strongly, markets become more inclined to price in a fall. After gold prices have fallen, markets err in favour of a subsequent rise. In the cyclical mining industry, price/earnings ratios are lowest near the peak in a cycle. They are highest near the trough.

The third flaw in the standard valuation approach is that it implicitly assumes cash flows accrue to investors. In reality, most of the cash generated will be deployed in new risky ventures, including exploration, greenfield mine developments or fresh business acquisitions.

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In soliciting funds, no company directors may have ever said that project execution will proceed flawlessly, the gold price is not going to change, all cash generated will be given to shareholders and no new projects will be pursued. Conventional valuation methodology bears little resemblance to investment reality.

Investors are continually tempted to think of likely departures from feasibility study outcomes. The possibility of a higher gold price, a bigger resource, acquisitions or a takeover are common blandishments to encourage reticent capital.

On the flip side, if expected conditions fail to materialise, directors retain an option to abandon any previously outlined plans.

Since strategic optionality is what investors are being asked to support, an options valuation methodology would make more sense than measurement of supposedly certain cash flows.

Buying a stake in Matador, or any like company, is similar to buying a series of call options. A capital outlay can be viewed as an option premium. An option pricing model explicitly allows for gold price and cash flow variability. It can accommodate expansions, closures or modifications to development plans.

The combination of a long life asset and a variable metal price adds value in a way the discounted cash flow model fails to measure.

The option model also explains how a company can have a positive market value without having a positive cash flow. It is a more general explanation of equity market pricing in a cyclical industry.

Let's take an example in which a company with a one million ounce reserve intends to produce for 20 years at a steady production rate after spending US$250 million. At a constant gold price of US$1,800/oz and all-in sustaining costs of US$850/oz, the value of the cash flows would be US$592 million, discounted at 5%. The net present value would be US$342 million.

Applying the Black Scholes option pricing model to the same set of assumptions would produce a more modest $150 million valuation.

Even if one concludes that neither the option model nor the discounted cash flow approach is a complete explanation of a gold mine investment, the valuation disparity at least provokes a question about what are the most important drivers of equity prices.

The options model proves more sensitive to resource extensions. If the gold reserve and production rate were doubled in this example, the option valuation would rise to $414 million, a near threefold rise and consistent with the rising market premium for larger resources.

Going back to Matador, the option approach predicts a project value of $39 million, still higher than the $28 million current market capitalisation of the company but by no means as large a valuation leap as implied by a discounted cash flow analysis of the project.

Option modelling throws up many valuation disparities among existing producers.

Regis Resources, for example, has a model value of US$1,532 million, 22% less than the current market capitalisation of US$1,953 million and well below a conventional cash flow valuation. A US$2,050/oz gold price would realign the Regis share price with its option model valuation.

Ramelius Resources, with a market capitalisation of US$1,140 million, is trading at a 65% premium to the modelled valuation of US$691 million. A gold price of US$2,300/oz would bring the Ramelius valuation into line with the market value.

The Ramelius chief executive has publicly foreshadowed a 50% expansion of the company's production base, without outlining any specific plans to do so. Investors might be already putting some emphasis on this strategic option in pricing the company as well as the possibility of a higher gold price.

The US$1,355 million Resolute Mining model valuation, some 45% higher than its market capitalisation of US$919 million, offers investors some upside potential. The Resolute valuation differential is consistent with the company recovering production momentum after having suffered an operational failure in 2019.

The choice of a cash flow model is legitimately driven by a need to know if loans can be serviced and repaid. How much an equity investor should pay for an asset surrounded by uncertainty needs a different analytical tool.

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