Discounting the future

In giving the Kasbah Resources takeover the green light, the independent expert gently chided the mining industry over its valuation methods.

John Robertson* | 10 Nov 2016 | 8:39 | Opinion

Financial models can be manipulated to give the outputs that best suit companies in raising capital

Directors of Morocco-focused tin-mine developer Kasbah Resources agreed to a takeover proposal from TSX-listed Asian Mineral Resources (AMR) in August, after conceding they could not get the necessary funding to go it alone.

To inform a shareholder vote, ASX-listed Kasbah commissioned an independent expert to provide an opinion about the value proposition behind the deal.

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Advisory firm BDO Corporate Finance, in its capacity as an independent expert, has labelled the proposed transaction both fair and reasonable.

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BDO concluded in late October that Kasbah shareholders would receive a benefit worth A$32.9 million (US$25.3 million) in exchange for the existing Kasbah business valued at $38.7 million.

Kasbah shareholders might justifiably feel a little miffed that AMR's existing Asian assets were valued at $14.7 million (or 23% of the value of the combined entity) by BDO. This came despite AMR's Asian activities having been placed on care and maintenance with little realistic prospect of any value being derived from the closed nickel properties. But that horse has bolted.

The deal is less than exciting for Kasbah shareholders who are effectively getting $0.85 in exchange for their $1 of value, according to BDO. Still, there is nothing better on offer despite Kasbah having put values of $101 million on its primary development asset in 2014 and $73 million, after some modification to the project, as recently as July 2016.

The BDO valuation is consistent with my own comments in earlier 'From the Capital' columns about the uphill battle faced by Kasbah to fund its tin project because of its modest return on invested capital.

"Financial intermediaries and aggressive corporate public relations outfits work the phones to sustain the lie"

The BDO comment motivating my urge to say 'I told you so' arose from the firm's consideration of an appropriate discount rate for valuation purposes.

Earlier columns have commented on a tendency for miners to exaggerate their investment attractions by using implausibly low discount rates to calculate project value.

BDO has helped bell the cat on just how misleading this behaviour can be. The accountant judged that a cost of equity between 10% and 14%, depending on the beta being applied to the risk premium, was appropriate in valuing Kasbah's project assets.

Kasbah, in reporting its own feasibility results over several years, had used a discount rate of 8% – even when long bond yields were more than two percentage points higher than they are now – without ever offering any analytical justification for the lower capital cost choice.

Nor did the company provide sensitivity analyses by which investors could decide for themselves how significant the discount rate assumption would be to their investment decision.

BDO observed dryly, in its report, that the net present value previously published by Kasbah "reflects a value at the project level, which is commonly used for a DFS, but does not necessarily reflect the return to equity holders".

If the information provided by the company to the equity market is not germane to an assessment of the value of its equity, what's the point? The information is either misleading or worthless.

The choice of discount rate is no trivial matter. It is an estimate of the return an equity investor should expect given existing market conditions. Saying equity investors should make do with 8% or 5%, as some do, is arrogant balderdash.

In the Kasbah example, the difference between 8% and 14% is equivalent to $37.5 million, a very large chunk of the prospective transaction value.

If pushed, companies will most frequently attempt to justify the selection of a dubiously low discount rate by saying they are just doing the same as other companies.

Using 'follow the leader' as an analytical justification is a conspiracy of convenience, which helps lure unsuspecting investors into supporting otherwise unsustainable investment propositions.

However harsh this judgement might appear, the clearest evidence in support of its validity, in the case of Kasbah, has been the inability of the company's directors to find investors with a similar view of value to themselves.

The dearth of acceptable funding alternatives is saying that the required return underpinning the company's expectations of project worth has been too low.

There is now apparent agreement on this point.

AMR and Pala Investments, its private equity backer, have made their assessment clear through the terms of their bid. An independent expert has said the same and, finally, Kasbah Resources has implicitly agreed that its asking price had unjustifiably inflated the value of its assets.

It would be unfair to single out Kasbah for criticism on this front as though it was the only offender. Its approach reflects a deeply ingrained cultural tendency within the industry to ignore the need to offer an adequate return on equity when assessing the viability of new investments.

Such a self-delusional blunder could be disregarded but for its wider and more serious sectoral impact.

Kasbah-type approaches replicated across the industry are the seeds of future disappointment and longer-term investor disenchantment.

Inflated valuations do attract investors when they are dressed up to appear analytically sturdy and given the imprimatur of seemingly credible industry followers.

Supporting financial intermediaries and aggressive corporate public relations outfits work the phones to sustain the lie.

Paradoxically, regulators also help by permitting companies to assert spuriously precise valuations based on otherwise untested, unsubstantiated and unproven assumptions about the cost of capital.

Multiply this prospect many times over and the credibility of the industry as a place in which to invest becomes needlessly and sorely tested.

This source of disappointment is different in character to the threat of uncontrollable risks from macro conditions, regulatory delays or start-up snags.

The blame for any negative impact on industry credibility arising from concocted valuations can be sheeted home entirely to those who exercise their discretion to make the choice.

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