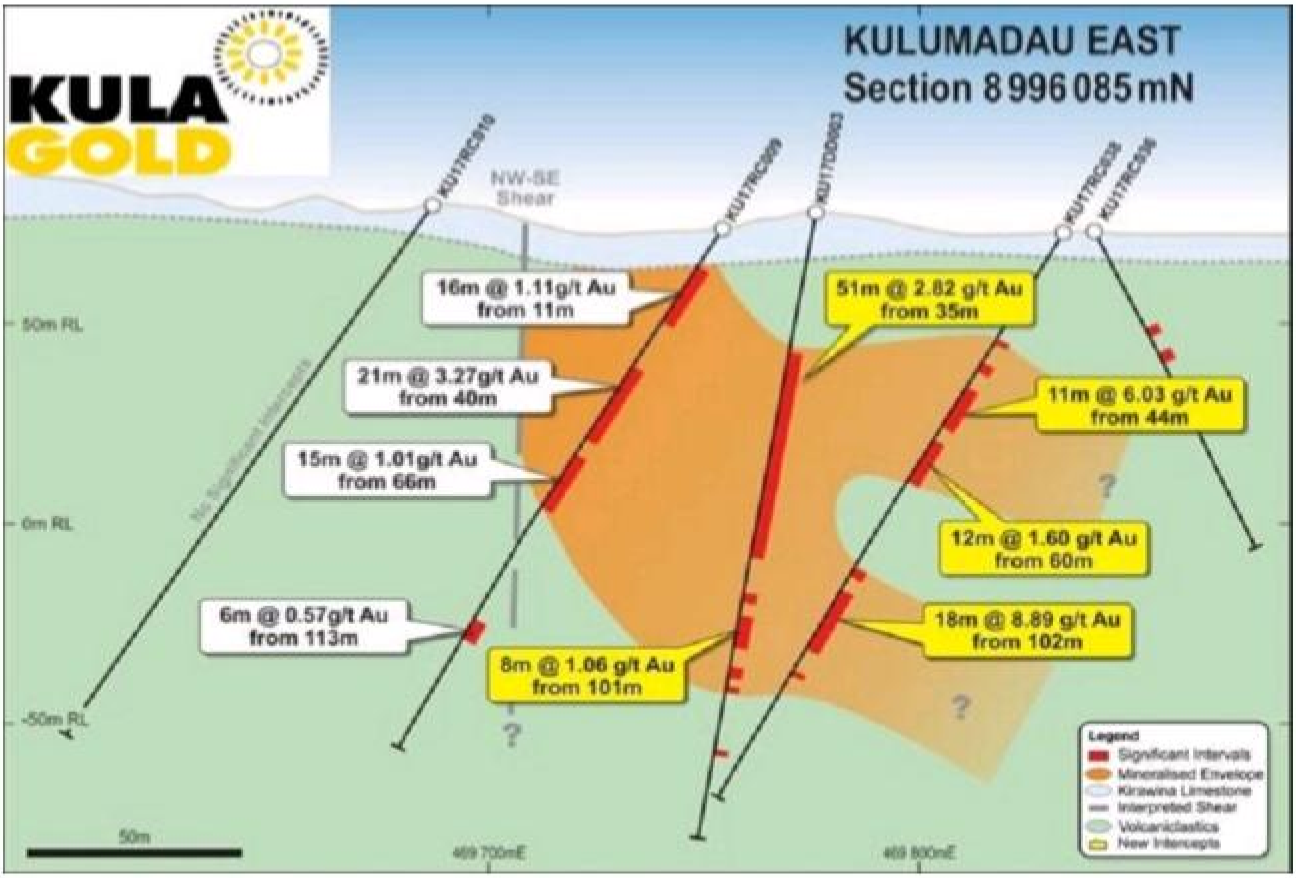
Mining Journal

Buy Kula, sell Geopacific!

The Geopacific Resources bid for Kula Gold threatens to leave a bloodied prey clinging to life with a frustrated and unsatisfied predator as the less attractive investment.

John Robertson* | 10 Aug 2017 | 11:09 | Opinion



The latest results from the Woodlark Island gold project continue to justify Geopacific's interest

Kula Gold has been trapped in the investment no man's land between exploration success and development completion.

The Papua New Guinea-focussed gold mine developer is just one of many companies coming out of the most recent investment cycle armed with project studies purporting to demonstrate commercial viability yet little discernible progress toward realising the latent value.

Foundation investors, in these circumstances, face increasingly diluted economic interests as they are forced to refocus on lengthened time horizons, give way to financially stronger investors eyeing off cheap assets or take losses.

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Kula Gold has held a 100% interest in the fully-permitted Woodlark Island gold project within a region featuring many multi-million ounce gold deposits.

In July 2012, the Woodlark mineral resource was estimated to contain 2.12 million ounces of gold in 45.1 million tonnes of ore grading 1.5g/t Au. Directors subsequently highlighted opportunities to raise the size of the resource to between 3-5Moz.

A September 2012 feasibility study based on the July resource estimate and a 766,000oz reserve put a value of US$237 million on a mine with a nine-year life, operating costs of US$852/oz and requiring a US$212 million capital outlay.

With a US$1,600/oz gold price, the project was expected to generate a return equivalent to buying a bond with a 21% annual yield over the life of the mine. Unfortunately, the gold price had begun falling almost immediately after the study was completed. At a US$1,200/oz gold price, the yield would shrink dramatically to just 4%.

"Insistence on a low-ball bid could invite accusations of duplicity and, if persuasive, damage the value of their own company"

Return estimates have also been inflated by ignoring the A$150 million (US$118 million) spent by the company and not included in the study's incremental capital estimate.

The pre-tax discount rate of 7% used for the valuation also proved inappropriate. It was struck shortly before the yield on low grade US dollar corporate debt – a sign of finance availability – rose from 8% to over 20%.

In July 2016, Geopacific Resources promised to extricate Kula from its predicament by taking over development and funding of the Woodlark Island property and spending up to A$18.65 million over three-and-a-half years.

In meeting its spending commitments and achieving agreed exploration targets, Geopacific would be able to earn a 75% stake in the project. If it also sourced 100% of the necessary finance, it could push its share to 80%.

Kula Gold could, under the terms of the deal, end up with a 15% project share after the PNG government took 5% in exchange for its share of money spent to that point.

Kula had little room to manoeuvre when confronted with the classic industry choice between a large share of nothing and an unfortunately small share of something beyond the reach of its own skills.

Geopacific made plain its aim to quickly expand the Woodlark resource, cut the needed capital outlay and get operating costs down to improve the project economics.

The new joint venture partner had not released an upgraded feasibility study before announcing in April 2017 that it intended to bid for all the outstanding shares in Kula Gold.

The timing was highly opportunistic but understandable. Having taken operational control of the project, Geopacific was acquiring an intimate knowledge of its potential and, in doing so, eliminating some of the normal transactional risks for a bidder.

Geopacific also knew that, with each passing day, an appropriately valued bid subject to independent scrutiny was going to become more costly.

The initial bid offered Kula shareholders one Geopacific share for each 1.4723 shares held in the target, valuing Kula at A$6.9 million.

Geopacific has been struggling to get the bid, originally scheduled to close on July 6, across the line. At the end of July, it decided to up its offer to one Geopacific share for each 1.1 shares in Kula to get the 37% holding of fund manager Pacific Road Capital.

Pacific Road, Franklin Templeton and RMB Resources, all of which have now accepted the offer, had accounted for 67% of the company's outstanding shares.

To get Pacific Road on board, Geopacific also had to abandon its 90% minimum acceptance condition leaving it at risk of having control but being unable to delist the company to get the simpler and more cost effective structure it had pitched as the reason for the bid.

If Geopacific is unable to eke out the needed number of shares from the remaining small shareholders currently with 28% of the stock, investors will have two ways of gaining exposure to the Woodlark project.

As things stand, a 1% project interest through Kula Gold would come at an effective cost of $225,000. A 1% interest through Geopacific Resources, on the other hand, would cost $750,000.

Price will be one consideration. Access to cash will be another in deciding which vehicle offers the better value.

Presumably, Geopacific will wish to drain any surplus cash from Kula through dividends to help fund other projects, including those currently held in Cambodia and Fiji. Dividends, matching the cash flows of the underlying project, are more likely through Kula than Geopacific

Also, any subsequent takeover attempt once Geopacific formally takes control of Kula Gold will have to pass the scrutiny of an independent expert.

If they cannot persuade enough of the currently recalcitrant Kula shareholders over the coming month, Geopacific directors will face an awkward and unusual valuation test in any future bid. They will have to put a price on their own work.

Insistence on a low-ball bid could invite accusations of duplicity and, if persuasive, damage the value of their own company.

As always, an investment decision will depend on an individual's own objectives but the safer place for a Woodlark investor, if needing to choose, may be in Kula Gold not Geopacific Resources.

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