MiningJournal

Scoping study blues well founded

Overly optimistic industry consultants have the same effect on the investment standing of the mining industry as lying promoters.

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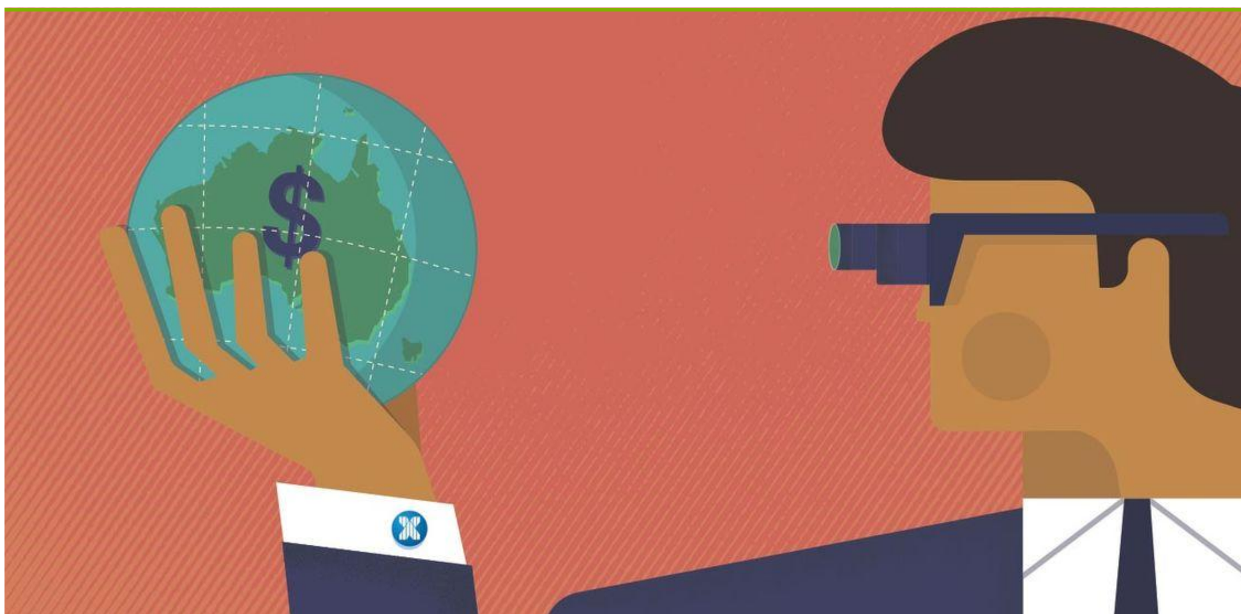

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Even years into a project's life cycle, mining industry investors must often guess at value. Experience with prior results from other companies in similar circumstances looms large as guideposts upon which to base judgements.

The hunger for information is strong. Questions about future production size, costs and capital requirements are routinely asked of company executives, if nothing is volunteered, no matter how menacingly market regulators may threaten retribution for an unapproved disclosure.

Scoping studies give investors one of the earliest chances to meaningfully grapple with value, despite all of the caveats, qualifications and disclaimers companies are required to attach to such studies.

At this stage, investors are especially sensitive about project capital requirements because of their impact on near term ownership dilution and the challenge of successfully completing disproportionately large funding tasks.

While later studies will prove critical to financing and engineering decisions, day-to-day investors rely heavily on the content of scoping studies to set the market tone.

To assess whether scoping studies have been reasonable guides to future capital needs, I reviewed the published details for 58 project-level scoping studies concluded during 2017 and 2018 by ASX-listed mining companies. Years before 2019 were selected to allow two years or more in which to measure the direction and extent of subsequent capital spending revisions.

Of the studies reviewed, 16 did not disclose anything about the quantity of capital needed because to do so would have contravened ASX guidelines about the acceptable certainty of resource estimates.

Australia's market regulators have been especially strict in policing publication of future financial performance in the absence of reasonable assumptions about the size and quality of mineral resources.

Where resource estimates are wholly or largely inferred, companies are banned from explicitly referring to production rates, costs, capital needs or asset values. They can acknowledge having compiled the relevant information. They can share it privately among sophisticated investors. But they must keep ordinary investors in the dark.

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Where greater confidence attaches to resource estimates, companies are freer to guide expectations about value. Estimates of pre-production capital spending were included in the information released for the remaining 42 of the 2017-18 reviewed scoping study projects.

A scoping study nominally seeks to estimate capital outlays within plus or minus 35% of the actual outcome. The range allows for changes in market conditions, more detailed engineering specifications, outcomes of commercial negotiations or altered operational assumptions. The indicated spread also clearly implies that the eventual capital spending could just as likely be higher as lower.

The symmetry in the distribution of estimate variations has important implications for investment decision making. Symmetry implies that investors are just as likely to experience a positive as a negative surprise. A consistently asymmetric distribution, on the other hand, suggests a tendency to disappointment, if the bias is in one direction, or positive surprise, if in the other direction.

A few projects came to nothing after being dumped explicitly despite supposedly positive results. In other cases, companies simply ceased referring to projects in favour of more tantalising options. Ten of the projects reviewed are ongoing without any update having been released.

Taking out these three categories left 23 projects with updated capital spending estimates. The trend is clear. The most recently stated capital estimate for every project is higher than the scoping study estimate. The average difference is 107%. The median difference between the original scoping study estimate and the most recent pre-production capital estimate is 57%.

The distribution of capital spending revisions is neither symmetric nor limited to 35%.

Scoping studies are based on the evidently false premise that capital needs are just as likely to be overstated as understated. This is a critically important misunderstanding where the fear of missing out is a powerful driver of investment money flows into any industry segment or asset class. A 50% chance of positive capital spending surprises would keep investors engaged.

If, on the other hand, investors' own experiences repeatedly confirm the near certainty of a negative surprise, enthusiasm will wane. Investors will rarely fear being underinvested. That casts a pall over return prospects.

Higher capital spending is not an inherently undesirable outcome. Return on capital, not the amount spent, dictates investment quality. Nonetheless, the data point to the prevalence of overly optimistic views being used to get projects off the ground.

Managers of companies at this stage of development usually have clear financial incentives to excite interest in their upcoming scoping studies and to make them as attractive as possible. The so-called independent consultants engaged to prepare scoping studies are also far from objective. They have no less skin in the game.

Since the livelihoods of consultants depend on a continuation of firm industry asset values and expectations of eventual development success, they are unlikely to question methods that artificially inflate asset values. The short-sighted promotion of unrealistically cheap projects is in the interests of

too many in the industry.

Industry commentators will commonly draw attention to a slump in investment returns in the aftermath of exploration success and before the start of production. Many will attribute this investment hiatus to an absence of news flow, ignoring the negative impact on investor sentiment of adverse capital spending revisions.

The culturally embedded tendency to inflate valuations at the early stages of a project by understating capital needs damages the standing of the industry.

Any investment sugar surge is not just short-lived. Worse than that, a scoping study becomes the most reliable possible warning of disappointment to come and, even if only subliminal, an incentive to drop a stock.

Until industry habits change, post-discovery valuation blues will remain a feature of the mining industry. Investment returns will be impaired. Funding a project at one of the most critical times in its life cycle will remain an unwise investment.

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