

Expert reports fail test

Independent expert valuation reports are becoming elaborate games of pass the parcel as participants prioritise ducking responsibility over analytical quality.

John Robertson* | 13 Apr 2017 | 6:12 | Opinion



Varying combinations of geology, metallurgy, logistics, project management, diverse geography and specialised markets greatly complicate the valuation problem in the mining industry.

Transactions involving non-producing and unfunded assets add complexity to the valuation task. Identifying directly comparable transactions against which to benchmark prices in a highly cyclical industry is another layer of difficulty.

To overcome such challenges, an independent financial expert will often seek the input of one or more technical experts when commissioned to produce a valuation report.

Adding to the available analytical skills should enhance the quality of the conclusions but, as the network of involved experts widens, responsibility for the final analysis is diluted. The end product can resemble a patchwork of inconsistently applied principles.

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Compromised reports are possible despite the extensive guidance from regulators and professional bodies about how valuations should be conducted.

In August 2016, for example, Kasbah Resources was subject to a takeover bid from Asian Mineral Resources (AMR).

The former had a tin mining opportunity under development in Morocco. The latter was placing nickel mining assets in Vietnam under care and maintenance as it sought a switch in strategic direction.

The valuation task, in essence, required a comparison of the worth of Kasbah Resources with that of AMR.

In practice, the appointed independent expert played no role in the AMR valuation, which it had delegated to others ostensibly meeting the relevant requirements for technical expertise.

"Casting doubt on industry asset values or the optimism of aspiring development companies would hardly help the businesses of the technical experts"

The group reviewing the AMR geological assets attributed no value to the depleted resource but thought the exploration potential was worth at least A\$1 million (US\$760,000) and perhaps as much as \$4.6 million.

Three quarters of the adopted AMR asset value came from a second consultant. It valued the company's residual capital assets in Vietnam after it had exited its mining properties.

Describing an entirely hypothetical scenario, the second valuer proceeded "based upon the assumption of the asset remaining in their continued use".

In the event the assets were put to an alternative use, the valuer conceded before discarding this assumption, their value would have been up to 95% lower.

Despite the disparity, the largely fictitious basis on which the selected valuation rested, and the consequential impact on the investment recommendation, the independent financial expert proved reluctant to second guess a consultant chosen for its supposedly superior technical knowledge and skill.

In August 2016, another independent expert was called upon by Northern Minerals to opine on the fairness of an issue of shares by the Western Australian dysprosium mine developer.

Again, the designated independent expert outsourced valuation of the mineral assets, which effectively made up the entirety of the company's value.

The independent financial expert described a discounted cash flow approach as "not appropriate at this point of time" because the company did not have a reliable cash flow or profit history. Moreover, the expert recognised the company would need to raise over \$329 million making a discounted cash flow valuation "theoretical as without funds [the project] will not be developed".

In March 2015, the company itself had attributed a value of \$552 million to its primary development project based on discounting anticipated cash flows at 10%.

Seemingly oblivious to the view of the independent financial expert and the company's prolonged inability to source development funds, the employed technical expert based its valuation on the company's published 2015 conclusions.

The technical expert did go one step further. It "created a distribution of certain DFS inputs and simulated 100 scenarios to create a probability distribution of possible outcomes" ranging from minus \$100 million to plus \$700 million.

Even this range may have been unrealistically narrow. Despite the Australian dollar being the input to which the company's valuation was most sensitive, the simulations limited exchange rate variations over the next 15 years to within 7% of the company's 2015 assumption.

Nor did the technical expert address the appropriateness or the impact of possible differences in the assumed discount rate. Including an equity component in the implied funding package (rather than all debt) might have pushed a weighted-average cost of capital estimate to 15% and stripped \$230 million from the value.

These choices imposed an upward bias to the valuation of a company investors judged to be worth just \$42 million, but which the supposed expert thought had a better than 50% chance of being worth \$400-700 million.

Evidently, being a little sheepish about the analytical bias, the consultant plucked a still steep value of \$201 million from the 25th percentile for use by the independent expert. Why this met the standard of a value at which the asset should change hands between a willing buyer and seller was unexplained.

Simultaneously, the consultant nimbly ducked responsibility for its own choices, volunteering that its "expertise is solely in geological consulting and as such, it relies heavily on the input from other experts".

Despite valuation being the primary endpoint of any independent expert report, judgments about the most important inputs affecting value were left, in this instance, in the hands of people who confessed to being out of their analytical depth.

Worse still, when choices had to be made, the heaviest reliance was placed on inputs from the company itself rather than from more objective expert sources.

A bias toward overly optimistic valuations is not surprising. The technical consultants to whom independent experts are delegating de facto responsibility for valuations rely on the prosperity of the industry on whose assets they are being asked to pass judgement for their ongoing incomes.

Casting doubt on industry asset values or the optimism of aspiring development companies would hardly help the businesses of the technical experts being recruited for the occasional public valuation effort.

Here is the problem: if technical experts from within the industry cannot be construed as independent, nor can misleadingly labelled 'independent' reports based on their conflicted analysis.

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