FROM THE CAPITAL

Gold juniors battle market forces

Mutiny-Doray link aimed at boosting value, but is that a given?

The attempt by Mutiny Gold and Doray Minerals directors to conjure value from merging the two businesses will battle to overcome the more powerful forces driving asset pricing in the industry.

Doray Minerals has been a recent success story on the Australian gold mining scene, having moved speedily from discovery to production at the Andy Well project near Meekatharra in Western Australia. After producing its first gold in August 2013, it expects output of about 80,000oz in 2014-15, but its resource base is only 5.5 times this production rate.

Mutiny Gold aims to get the Deflector deposit in WA's Murchison region into production in early 2016. It is anticipating a six-year production rate of 63,000oz/y. With the benefit of copper and silver by-product credits, Mutiny says it will have all-in sustaining costs below A$725/oz (US$632/oz). Doray reported actual costs of A$1,044/oz for 2013-14.

The number one benefit for Mutiny shareholders cited in the presentation accompanying the merger announcement was an "immediate and material increase in value through a… premium to recent trading".

The benefit was so immediate it actually happened before the announcement was released. Over the six days running up to a company requested trading halt, the Mutiny share price rose as much as 59%. On the day before trading was halted, the volume of shares was more than three times higher than the daily average over the prior 12 months.

The price action leading to the announcement is not a good look. There may have been no misbehaviour. It could have been the product of sound thinking by skilled analysts. Most likely we will never know for sure, leaving investors to their nagging doubts about the integrity of the market.

Since the brief flurry of pre-announcement trading, the Mutiny Gold share price has given up all of its gains – plus some more. Sector prices have been tumbling but the market is firmly expressing disappointment.

The transaction goes to the heart of a profound strategic challenge confronting gold miners: how to create an investment proposition without a constantly rising gold price.

The Doray perspective on the deal is easy to understand. Mutiny is a quick supplement to resources. A Mutiny Gold shareholder, on the other hand, must be asking why a A$20 million company with a project worth A$111 million according to a feasibility study should shackle itself to an apparently weaker partner.

Hammering out a deal… merger between Doray and Mutiny Gold is expected to create a more valuable company

The transaction would not be happening without this disparity between advertised project values and actual market prices. Doray can hold out a solution to the value gap for frustrated Mutiny shareholders while reconfiguring a threatening decline in its own production. The game plan might work without the intervention of more powerful countervailing forces.

Firstly, equity investors are sceptical about the gold price outlook. The Mutiny feasibility study used a US$1,300/oz gold price to value the Deflector project at A$111 million. Just changing the gold price to US$1,150/oz would imply a project value below A$70 million in present value terms. A gold price of US$900/oz, not beyond the bounds of chance, combined with the current Australian dollar exchange rate would produce a project value only just equivalent to the current market capitalisation of the company. Depending on one's view of the gold price trajectory, the value disparity may be an illusion.

Secondly, the industry has a disappointing history of cost management. High-cost inflation, equivalent to an ongoing fall in the gold price, erodes project economics. Despite having no basis in recent history for assuming that today's costs can persist, valuations effectively assume they will. Markets are saying they will not.

Thirdly, the industry is neither structured nor culturally inclined to return the cash flows anticipated by consultants' valuations. A Mutiny Gold investment would be attractive if shareholders could count on the potential financial return being channeled back to them. A sceptical market is saying this is not about to happen. Investors are saying they are not going to pay for something they are never going to get.

In recommending approval of the merger by shareholders, directors of Mutiny Gold are implicitly conceding their own lack of faith in being able to deliver the claimed value proposition. Or, put another way, they have inaccurately portrayed the risk (assumed to be reflected in a meagre 8% discount rate) in promoting a value for equity investors.

In making out their cases for the combination, the companies have argued that a production base twice the size of either existing company would propel the new entity into a different peer group. Without any change in operating plans, the two companies would be worth more than their separate valuations today, according to this argument.

The companies have produced some data to make this point. What Doray and Mutiny do not volunteer is that the five companies identified as potential peers and valuation benchmarks for the new entity have considerably longer mine lives than anything they can presently offer. There is intrinsic value from having a longer operating life. Where two companies have the same current production and costs, a market should always pay more for the one with the longer operating life. Also, a long mine life enabling companies to ride out multiple cycles reduces investment risk.

These sources of value are not captured in an earnings snapshot based on current production. The company with unsustainable production due to a small resource base can easily appear cheap in comparisons using earnings or production as the measure of performance.

Adjusted for resource size, the values of the five companies cited by Doray Minerals and Mutiny Gold imply a value for the merged entity within 10% of their current combined market values. In other words, there is very little upside from the merger due to a re-pricing based on production. Investors looking for a reason to stay need to look elsewhere. ▼

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