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More ASX disclosure changes needed

Mod Resources has given us a fresh model for acceptable ASX disclosure practice with the first scoping study report since ASIC revamped its disclosure guidance in October.

John Robertson* | 15 Dec 2016 | 4:53 | Opinion

In focus: ASX-listed miners facing sharper scrutiny of scoping study language, but not necessarily assumptions

For much of 2016, the Australian mining industry has been at loggerheads with the country's investment market regulator over disclosure practices. How companies use scoping studies has been a particular bugbear.

ASIC seemed to be saying that, contrary to past practice, proof of funding was needed to back up a scoping study valuation. The industry was horrified at the prospect of no longer being able to use scoping studies as teasers to attract investors, one of their principal purposes.

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Speaking at the annual Mines and Money conference in London, Mod Resources executive director Julian Hanna said regulators were going through the announcement describing his Botswana copper property study in unusual detail.

Regulators would have been aware that the first cab off the rank would become a model for others to follow.

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In the end, the appearance of the delayed Mod report differs in three ways from an equivalent document a year ago.

• Highlighted upfront is a lengthy disclaimer warning investors against basing a decision on the information contained in the document.

• In an even more marked departure from previous practice, directors have enumerated reasons for believing future funding was available.

• References to project value which have typically been included in headlines at the top of announcements have been relegated to the body of the document.

Each of these modifications to prior practice – designed to protect private investors from the exaggerated claims of companies about their investment potential – can be linked to the most controversial areas of the revised ASIC guidance note.

While well-motivated, ASIC's approach will not always be consistent with the efficient functioning of investment markets.

Undoubtedly, left to the imaginations of their directors, many companies would make unsubstantiated claims about their worth. ASIC can prevent this happening in more formal written documents but has less control over the content of other communication media.

The more circumscribed companies feel in their formal reporting, the greater the risk of them using alternative routes to communicate with selected investors. The resulting asymmetric distribution of information will undermine market integrity.

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By forcing companies to quantify the risk of each key step in their development plans, an overall chance of success can be assessed. So, for example, if a company needs to complete eight critical steps to realise its value target, each with a probability of 80%, the company will have to admit that its overall chance of success is approximately 17%.

Knowing this, investors will be better armed to judge whether the proposed investment is consistent with their risk tolerance. Such an approach would also allow investors to track how the risk profile changes as time passes.

Without this more radical approach and if the Mod Resources announcement is the new paradigm for industry disclosure practices, reform on a further six fronts is needed.

1. The word 'robust' as a descriptor of scoping studies, widely used in the industry as an investment lure, should be eliminated. The Mod Resources announcement tellingly uses the word 'robust' 14 times in 17 pages and the word 'risk' only twice.

However, carefully crafted, a scoping study contains too many uncertainties to conform to the definition of robust, namely, there being little change in outcomes under a range of alternative scenarios.

2. Point estimates of project value in a scoping study are too spuriously precise and should be disallowed.

In the case of the Mod Resources study, a capital cost at the upper end of the assumed range of ±35% and a copper price assumption at the lower end of the ±20% range, for example, would strip more than US$170 million from the base case project valuation of US$180 million to leave a corporate value increment of less than A$10 million for a company with a market price of A$42 million.

Valuations should, if used at all, be placed within a sufficiently wide range to accurately reflect the potential variability in underlying assumptions.

3. Discount rates should require justification. Plucking nicely rounded numbers like 5% or 10% from the ether irrespective of capital market conditions is akin to using standardised grades in resource estimates without regard to local conditions, a course almost impossible to conceive as acceptable behaviour.

4. The currently misleading use of internal rate of return calculations should be stopped. It turns out the best way to boost returns is to ignore how much is spent.

Mod Resources has issued capital along the way worth A$65 million but, consistent with industry practice, measures returns on only the last US$94.5 million to be spent after making a project commitment.

Other examples of companies steadfastly refusing to bring highly material amounts to account in calculating returns include Kasbah Resources and Pilbara Minerals which have spent over $60 million and $40 million, respectively, outside the amounts on which their project returns have been calculated.

5. Companies should explicitly acknowledge the potentially dilutive effect of project funding arrangements on existing shareholders.

Reports should go beyond vague remarks about recourse to ‘conventional debt and equity funding’ to indicate the extent of dilution for each ten percentage points, for example, of equity funding for the project being valued.

6. Rather than having to rely entirely on company summaries, investors should have easier access to scoping study reports to source missing information.

Taxes, hardly an optional expense, could reduce the base case pre-tax valuation presented by Mod Resources by as much as US$35 million if statutory tax rates were to apply but we are not told. Nor is there any discussion of the sensitivity of the potentially inflated valuation to exchange rate change.

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