Mining Journal

Expert queries tin-miner risk

Kasbah Resources directors want us to believe that an investment in the Moroccan tin mine developer carries no more risk than a holding in an S&P 500 company.

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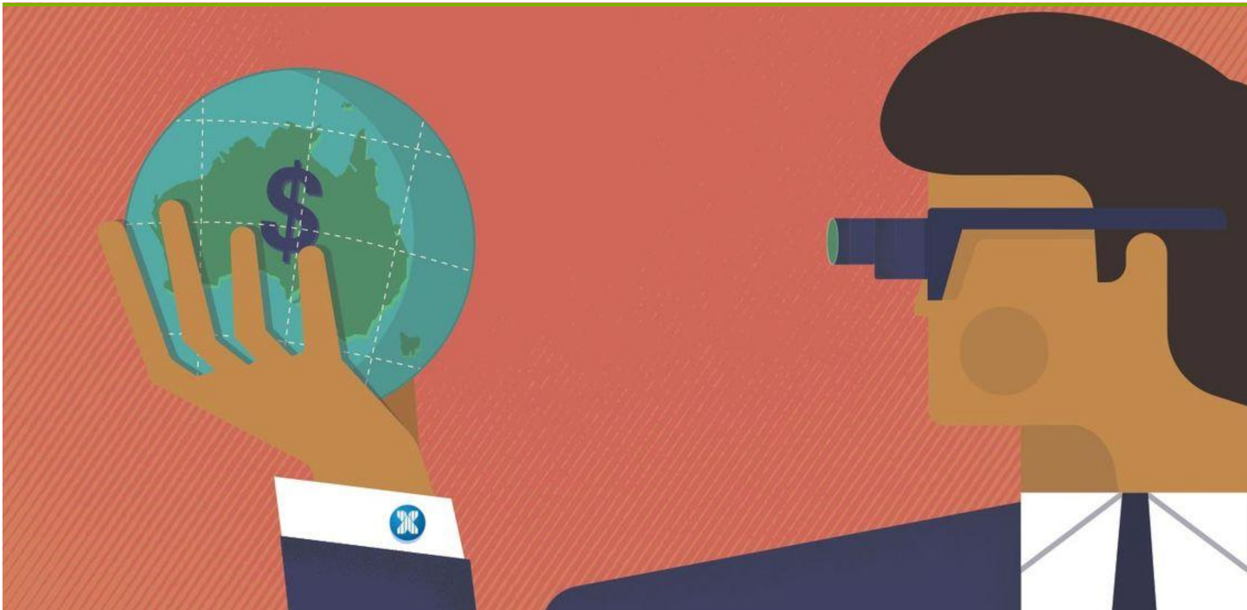

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To value the company's Achmmach tin project in Morocco, Kasbah Resources directors used an 8% real discount rate. The company's chief executive has referred to the resulting US$73.6 million project value for the company's 75% interest as indicative of the potential appreciation from a lowly market capitalisation of $6.8 million.

Kasbah Resources has adopted an approach typical of companies in the sector and, in common with others, has offered no reasons for its choice of financial metrics despite a requirement within the JORC Code to explain "the source and confidence".

Company executives might have forgotten but a capital asset pricing model sits behind the cost of capital measures normally cited by the industry, its advisers and experts employed to opine on value.

The cost-of-equity calculation used most widely has three components: a risk-free rate of return; a measure of excess return to reflect equity market risk; and an estimate of risk peculiar to the company, referred to as ‘beta'. Beta is intended to measure the prospective variability in asset returns relative to the variability in returns for a market benchmark. Of these, beta is the one open to the greatest discretion.

The risk-free rate is usually taken to be the expected yield on government debt of an appropriate maturity, normally 10 years. Currently around 3%, that is widely expected to rise to 4%, based on US Federal Reserve projections about the direction

and level of future interest rates. The risk premium has been the subject of various analytical efforts but 6% is most commonly used.

Implicit in the Kasbah assumption of an 8% cost of equity (assuming a real yield of 2% and a 6% risk premium) is a beta of 1.0. In other words, the risk characteristics of the company relevant for valuation purposes have been deemed no different to the S&P 500 benchmark equity price indicator.

Investors will be inclined to eschew the industry in reaction to continually dashed expectations as development success, predicated on unrealistically framed value attributes, proves elusive.

Intuitively, this hardly seems right. The historical meanderings of Kasbah Resources toward a development commitment over the 11 years since listing and described in previous 'From the Capital' columns have left the company in urgent need of a financial lifeline. Shareholders are being asked to approve a line of credit at a meeting in the coming week.

The independent expert recruited to offer an opinion has acknowledged 8% as being "a typical discount rate that is adopted by mining companies..." but went on to observe that "purchases of mining companies and mineral assets, where the principal asset is a pre-production stage project based on a completed feasibility study, usually apply an additional development risk discount". In other words, in the real world, investors use a higher beta than companies adopt when they value their own assets.
The independent expert drew on an analysis of 99 mining companies globally to conclude that a beta of 1.2-1.5 should be used to estimate the notional cost of equity against which the value of future cash flows should be judged.

The difference in beta assumption means a difference in the cost of equity of up to three percentage points which, according to the company's October 2018 feasibility study, would strip $24 million in value from the company's share of the Achmmach project.

The expert's analysis gets us closer to a more realistic assessment of investment risk but even that looks a tad too generous. The companies on which the expert's beta calculation was based had a median market capitalisation of $719 million suggesting an overwhelmingly different history and radically different risk profiles to that of Kasbah or, less compellingly, an imminently amazing transformation in the prospects of the budding Moroccan miner.

Analysis of monthly share price data from the past five years for Kasbah itself confirms a beta of 2.5. The implied nine percentage point increase in the cost of capital over what the company had assumed, if this measure of risk was adopted, would eliminate 95% of the value of the Achmmach project.

And, while on cost of capital measures, it is also worth noting that there is nothing attributable to jurisdictional risk in the company's discount rate. Flippant company references to Morocco as "southern Spain" hint at what directors want people to believe about country risk.

In a more analytically rigorous process, Professor Aswath Damodaran from the Stern School of Business at New York University publishes risk premiums for over 190 countries based on debt ratings and market default spreads. In January 2018, he estimated that the country risk premium for Morocco was 2.88%. Notionally, this would strip another $23 million from the project value. Damodaran's estimate of the Spanish risk premium is 2.19%.

Against this background, what might have appeared an inexplicably depressed share price suddenly becomes the epitome of reasonableness.

Working backwards, the existing Kasbah share price implies a corporate beta of around 1.8, a seemingly plausible number given the history of the company and the location of the project. The risk perception

by both the company and the expert is out of line with how real world investors had sized up the opportunity.

Habitually ignoring risk measurement gives rise to valuations best described as wishful thinking rather than demonstrating the robust economics so frequently claimed. The damage is real.

Misleading project economics can lead to less extensive resource definition efforts resulting in suboptimal development plans with negative impacts on the welfare of national resource owners.

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Limited capital resources are deployed inefficiently when risks are not more realistically appraised making it more difficult for the industry to compete for funds.
The seemingly cavalier approach to risk assessment would not matter so much if its consequences were confined to those directly responsible for damaging the industry's standing but the investment debris is scattered across a far wider array of stakeholders.

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