Chesser investors reassess development risks

Gold junior's bird in the hand may be a rare one indeed

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Chesser Resources Ltd shareholders must decide whether the bird in the hand is more valuable than the prospect of future gains from mine development. In voting to sell the company's Kestanelik project in Turkey, they will be given the chance to size up the project risks more realistically than they might have done when originally investing.

Chesser has called a meeting for 13 October for shareholders to vote on whether to accept a US$40 million bid from Turkish conglomerate Nurol Holdings for the Kestanelik gold project in the northwest of the country.

To buy the asset, the company has had to spend US$2.8 million since October 2009 and issue 900,000 shares with a current market value of A$135,000. A 2.5% net smelter return royalty would also have been payable to the project vendor.

The Kestanelik property consists of some 30km of epithermal quartz veins. Test work indicated 92-96% recoveries using industry-standard carbon-in-leach technology. Studies in 2013 were initially based on a 462,000oz resource producing 63,000oz of gold a year at a cash cost of US$415/oz after development capital of US$88 million and sustaining capital of US$26 million. A feasibility study valued the project at US$103 million using a gold price of US$1,300/oz and a 10% discount rate.

The company has more recently lifted the resource to 746,000oz of gold classified as indicated (32%) and inferred (68%) with a proposed 80,000oz production rate. It has confirmed pre-production capital costs of US$88 million would rise to US$100 million after start-up working capital needs are met. A further US$10 million would have been needed for a definitive feasibility study.

Raising the capital, no matter how good the project looked on paper, would have been a challenging task for a company with a A$20 million market value. The state of the capital market is one of the main reasons cited by directors for their decision to sell, rather than stay the distance.

In saying that, cash of US$40 million today, or US$37 million after transaction costs, is equivalent to or better than a net present value of US$103 million from operational cash flows, directors are saying previously published studies are missing something important.

Drilling at Kestanelik

To justify their stance that the proposed deal should be approved, directors are telling shareholders that earlier assessments did not take adequate account of "permitting risk, gold-price risk, construction risk, exploration risk, sovereign risk and other potential risks that could jeopardise ultimate returns".

The balance of the argument has been tilted toward a particular outcome. If there had been no bid for the property, directors would not have been so forthcoming about these eventualities. Most likely, they would have readily accepted investors ignoring such risks entirely if it had resulted in a higher share price.

As this column has observed on earlier occasions, analysts doing feasibility-study valuations are habitually underestimating the risk profile of projects they are valuing. A study for Pilbara Minerals of the Tabba Tabba tantalum project in Western Australia is one of the more egregious examples of the problem. A February 2014 feasibility study used a 10% discount rate to value the project. In March 2014, when the company raised the capital assumed in the study, it cost over 40%.

The actual amount paid by Pilbara Minerals more closely reflected how much risk real-life investors thought existed. In the case of Chesser, the discount rate implied by a US$40 million valuation would be near 20%. Given the current state of capital markets, this may not be an unreasonable assumption. Intuitively, this is the judgement being made by Chesser directors and shareholders would be hard pressed to prove them wrong.

Ironically, in promoting the Kestanelik deal, the Chesser directors are also inadvertently putting the arguments for staying clear of the company in the future. If the risks associated with "recent developments in international capital markets and the regulatory environment in Turkey" are enough to abort development of Kestanelik by the company, investors must surely ask why "Chesser will maintain an exploration presence in Turkey by continuing exploration at its Sisorta and Catak projects".

Given what the company has said about the Turkish development risks, little value should be ascribed to the remaining properties unless Chesser can treat them as trading stock in an effort to repeat the Kestanelik deal, rather than as new development opportunities.

The company has flagged that it will distribute up to A$0.15/share after the deal is approved by shareholders. Prior to the transaction being announced, the company's shares were trading at A$0.09. The value of the transaction was equivalent to A$0.167 and, at the time of writing, the share price is sitting on A$0.155.

Once the capital distribution is completed, the company could be left with a market value of A$4-5 million. This would not be out of line with the prices for other similarly positioned early stage explorers as Chesser would then be as it falls back along the development curve.

Chesser investors may not have got a mine, but they will have had better than normal value for their money. Many companies contemplating a mine development would be hoping for Chesser's stroke of luck in finding a way out of their funding and development predicaments to claw back some value for their shareholders.

Mergers and acquisitions are often touted as a reason to invest in the sector. The Chesser experience might be used to support the thesis. But where lightening strikes is hard to predict. More than just project quality and financial returns play a role. There are not yet enough examples of it happening for a positive impact on valuations to ripple through the sector. ▼

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