

## Opinion

FROM THE CAPITAL

# Orbis Gold confronts reality

No cheap money available for development, as highlighted by real-world transaction values

John Robertson

One company CEO took me to task recently for my criticism of project valuations based on unrealistically low discount rates but, even in the past week, there was fresh evidence of the disparity between what is being used to promote investments and what is achievable.

Mining companies frequently use feasibility study valuations as bait to attract investors. The pitch normally goes along the lines of "this project has an NPV of \$500 million compared to my company's market value of merely \$10 million".

There is nothing necessarily wrong with using the difference as an investment market lure. Costs have normally been refined, reviewed and reiterated using both internal and external sources of information. Revenue estimates will have been the subject of extensive market studies. Sophisticated mine planning models will probably have been used in conjunction with process testing.

The problem mostly arises from the way in which this information is packaged. Despite the size of its potential impact on the result and the effort put into other aspects of feasibility analysis, the discount rates used to take account of the time profile of production and the cost of capital are frequently little more than an off-the-cuff assumption.

Discount rates as low as 5% are common despite a near-zero chance of this being an acceptable rate of return for any equity or bond investor putting money into some of the market's most risky endeavours.

The argument put to me for using a discount rate as low as this is that others are doing the same. Certainly, repetition affords some cover but comes with consequences. Replacing absolute value standards with relative value measures helped create market excesses in 2008 and 2000 when herding investors were misled about the absolute risks they were incurring.

The second counter to my argument for a change in behaviour is that investors are smart enough to recast valuations using whatever assumptions they may prefer. True, some are but such mathematical and financial agility is more likely to be found among institutional analysts. Repeated references in the course of a presentation to a seductively wide gap between a current price and a project value will be enough to persuade many retail investors.



*Coin of the realm ... Burkina Faso focused Orbis Gold has conceded to acquirer's value argument*

Of course, if investors are so adept at crunching their own valuations, a company should be indifferent to using 5%, 15% or any other number because it would have no effect on the propensity to invest. No-one believes this to be true. Low discount rates help to attract investors. Many projects would look shabby if real world capital costs were used instead.

This week, ASX-listed Orbis Gold struck a takeover deal with Canadian-listed SEMAFO Inc. In October 2014, SEMAFO first foreshadowed a bid for the shares of ASX-listed Orbis Gold at a price equivalent to US\$143 million. Orbis directors advised shareholders to refuse such a cheap and opportunistic grab for their company. The principal asset of Orbis is the Natougou gold deposit in Burkina Faso which the company had valued at US\$533 million.

On Wednesday, the same directors recommended a deal pricing the company at US\$137 million. Put aside the dubious negotiating skills which resulted in a lower transaction value four months on and after a near 30% rise in the price of gold equities. The result says much about the discount rate the custodians of the company were applying to the project themselves.

Accepting US\$137 million today for a project with cash flows of US\$639 million over seven years implies a discount rate well in excess of 30% not 5%. In practice, the 5% number underpinning the valuation promoted by the company had no analytical

merit. The decision by Orbis directors is compelling proof.

Orbis Gold also commissioned an independent expert to value the company to bolster its case against the SEMAFO offer. The independent expert concluded that an appropriate cost of equity to use in valuing the project would have been in the range of 16.6-17.7%.

The expert also judged that the cost of debt would sit somewhere between 7% and 8%. There is one simple test for the validity of this assumption. If a company is unable to raise any capital at the suggested price, there is a strong chance the price is wrong. There was no funding at this price available for Orbis.

Another insight into the true cost of capital comes from mineral sands miner TiZir Limited. This company, jointly owned by ASX-listed Mineral Deposits and Eramet SA of France, operates the Grand Cote mine in Senegal and the Tyssedal ilmenite plant in Norway.

TiZir has US\$275 million in corporate bonds on issue. The yield on those bonds is 23%. This is the cost of capital for a company with market access.

Falling market yields on government securities are reflecting central bank demand and a flight to quality by commercial banks seeking to reconstruct their balance sheets. Since mid-2014, yields on US

dollar bonds issued by companies with ratings of CCC or lower, on the other hand, have risen 340 points despite the 70-90 point fall in German and US yields on 10-year government debt. The risk premia being demanded by financiers generally are rising.

Companies evaluating new opportunities have been very slow to catch up with these changes. Inflated valuations are based on a set of outdated market assumptions.

It may be that smart investors can do the sums for themselves, as those taking this route to attract investors contend. If not, these practices risk more damage to the reputation of the sector. An Orbis Gold shareholder will surely be instinctively more suspicious, and perhaps even hostile, when next confronting a project valuation. ▼

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