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Questioning the most emphatically expounded investment propositions might create resentment but is rarely unjustified.

John Robertson* | 20 Oct 2016 | 7:19 | Opinion

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The crash of the housing market was underpinned by a lack of rigour and acceptance of false assumptions

Every investment proposition has at its heart a single critical assumption underpinning success. Sometimes, that crucial assumption is advanced with such uncompromising self-belief that it goes largely untested.

Mortgage securitisation, for example, is now seen as always having had a fatal flaw capable of destabilising a financial system. Underpinning its popularity even among supposedly conservative investment institutions was a view that real estate prices were headed in one direction only.

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Very few individuals bucked the conventional wisdom.

Once upon a time, the mining industry gladly embraced the idea of a commodity price super cycle. Billions of dollars were poured into projects on the assumption that, contrary to the entirety of human experience, cycles would only move in one direction.

Few cautioned that a super cycle came with a correspondingly greater fall than an ordinary cycle.

At a company level, too, the assumptions promoted most aggressively are the ones which usually take too much for granted and warrant the most active questioning.

The state of the lithium market as an equity price driver is a case in point.

Orocobre chief executive Richard Seville's appeal to investors focuses on strong lithium prices based on the assumption that "the lithium chemical market will remain in deficit".

Despite setbacks along the development path, Orocobre qualifies as one of Australia's most successful mining companies. The developer of a lithium brine deposit in Argentina is at the forefront of a new generation of miners taking advantage of the burgeoning growth in battery storage applications.

Whatever happens to the lithium market, Orocobre is set to remain an unusually long-life investment choice with low end costs enabling it to position itself as a core element in a diversified sector portfolio for both individual and institutional investors.

The company is gradually establishing itself as a credible product supplier but its Olaroz plant is still operating below nameplate capacity several years after the company had originally foreshadowed reaching an annual production rate of 17,500 tonnes. The company's production costs also continue to run ahead of foreshadowed operating costs.

A simplistic appeal to lithium prices is no longer enough to justify an increasingly complex investment.

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The underlying investment proposition, which relies on an indefinite deficit market, is faulty and at risk of failing.

Orocobre's market price still partially reflects exuberance over lithium market conditions and the scarcity value of lithium mines in an industry still reeling from otherwise depressed cyclical conditions.

The Orocobre share price is 137% higher than at the time of the most intense cyclical weakness in the sector at the end of 2015. But Orocobre has been in the midst of a critical transition in the way people think about its investment potential.

Since July 2016, the Orocobre share price has fallen 35% despite the company's progress toward its operating goals and continued buoyancy in lithium demand.

A long-term lithium carbonate price of US\$10,000 per tonne implies a currently generous market capitalisation of 6-6.5 times its share of future, as yet unachieved, operational cash flows.

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"BCL was portrayed as an investment safety net when it was, in fact, an investment Achilles heel"

Near the peak in iron ore prices in 2011, BHP Billiton was priced at a more miserly four times its realised operating cash flows.

Valuation plays an increasingly important role for companies at Orocobre's stage of development as speculation about market conditions and timing of project completion give way to an analysis of profit trends as a basis for pricing.

As this transition proceeds and the earlier stage investment drivers no longer apply, a company's market rating can decline even as its earnings rise and it closes in on its operational objectives.

Meanwhile, on another continent, the government of Botswana has confirmed the appointment of a provisional liquidator to BCL after deciding it could no longer cover the losses from the mine and smelter operator.

Abandonment by the Botswana government of the state-owned miner has pulled the rug from under the investment proposition of ASX-listed Botswana Metals. The now A\$2.3 million (US\$1.8 million) Australian company had promoted BCL as a source of exploration funds and a home for any resulting mine output.

BCL was portrayed as an investment safety net when it was, in fact, an investment Achilles heel.

Excelsior Gold also pulled the veil from a faulty investment proposition in the past week. A new group of directors acknowledged its tolling agreement with Zijin Mining Group subsidiary Norton Gold Fields was more troublesome than the company had let on.

The company's earlier claim that the "milling partnership has been structured to accelerate cash flow delivery and maximise volumes through the plant" had underpinned its investment proposition. The arrangement was supposed to give it an investment edge other companies did not have.

The company now says it gets paid more slowly than if it had its own plant. It also believes Norton may delay processing its material if it can source more profitable ore elsewhere.

Excelsior Gold provides another example of a fundamentally important assumption going untested simply because it had been asserted vigorously enough to stifle scrutiny.

Removal of a widely held assumption about an investment does not always damage investors. This week, Whitehaven Coal reported strong sales gains for the three months ended September 2016 with higher coal prices still in the pipeline.

Some of the world's best known investment houses had forecast the permanent demise of coal investments as their evangelical zeal seemed to blind them to how markets work.

An eightfold rise in the market value of Whitehaven Coal has been spurred by a combination of higher coal prices, growing production and impressive operational outcomes. There is still money to be made from coal.

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