FROM THE CAPITAL

Kasbah optimism was foolhardy

Junior shows industry is still refusing to face up to real world risk factors

John Robertson*

Achmmach 3.0 is a fresh attempt by Kasbah Resources to breathe life into its stalled Moroccan tin development.

One of the riskiest phases for investors in the mining project development cycle comes after companies have demonstrated the existence of a resource with commercial potential. Having passed the point at which it can force a reassessment of market value from exploration surprise, a company may yet be unable to display sufficiently convincing project economics to get development underway.

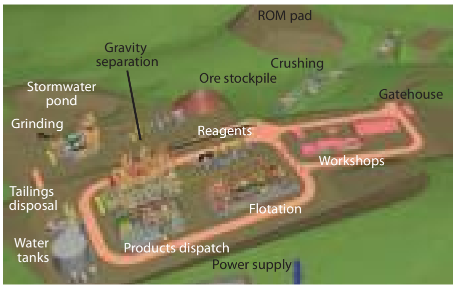
There is a risk of this 'phase one' value trap being prolonged and extending well beyond a reasonable investment time horizon. In some extreme cases, the transition may never be completed or may only happen after the passage of multiple cycles.

In 2014, Kasbah Resources seemed one of the best positioned of the world's mine developers to conclude offtake and finance deals in a bid to move quickly to development. Kasbah has subsequently proven to be an instructive case study in the interaction of development plans and the macro environment needed to permit development.

Overlying the normal challenges facing a company at this stage of development, a consistently bullish view about tin prices and overly optimistic views about capital market conditions have seemingly biased its development decisions, possibly to the detriment of its investors.

A 2014 Achmmach feasibility study was based on a US$23,025 per tonne tin price. A second round of study results published a year later were based on a price of US$21,511/t, even as the price at the time had fallen to $17,400/t. Resulting project valuations were as high as US$171 million when the market value of the company was A$19 million (US$13.6 million). The valuation gap appeared to endorse the optimism expressed by the company about the prospects of the project.

In July 2015, after the actual tin price had fallen another 17%, the company was still holding out for "an anticipated strengthening of the tin price". So strongly held was this expectation that the company rejected "strong indicative offers of debt from several European banks and development agencies", preferring to hold out for "additional and more competitive financing terms" expected to come after tin prices rose into the end of 2015.



The layout of the Achmmach operation is a nice idea but is still far from reality

Many companies at this point would have been happy to grab what was on offer to get development underway. Kasbah directors backed their judgement about future prices in a high risk and, unfortunately, analytically flawed strategy.

As outlined in my June 26, 2015, column, Kasbah directors failed to take account of exchange rate movements when forecasting US dollar denominated metal prices, even while the US dollar was in the midst of a once in a decade departure from its long-term trend.

Kasbah's decision to bet on higher prices highlighted the dangerously ad hoc nature of commodity price forecasts among companies within a sector in which wishful thinking very easily substitutes for analysis.

Companies are likely to display more rigour finding out the price of a truck without any material impact on the eventual investment decision than analysing the single most important input into a project valuation.

The Kasbah experience also raises an important governance question. Who takes responsibility for a forecast that goes wrong? In practice, in the mining industry, the answer is clear: no one.

Mining companies are inclined to blame others for missed forecasts even as, in the case of Kasbah, the chosen methodology was unsuited to the task.

Available analytical techniques for assessing and taking account of forecast risk are simply eschewed by the mining industry. Complete neglect of any form of forecasting loss function suggests the show of rigour displayed in feasibility studies is pretence rather than substance.

So, now, Kasbah remains in that highly dangerous transition between 'phase one' and 'phase two' of the development cycle.

By any normal standards, the Achmmach deposit should be developed. Whether that happens within an acceptable investment timeframe is another matter. It should still be among the best placed to move to the next stage, but the company's own track record may hinder positive conclusions about the outcome.

This month, Kasbah Resources advanced an alternative development vision involving a much smaller call on capital. Cutting the project cost from US$148 million to US$56 million means lower production but a slightly longer project life without much difference in operating costs. The newly framed plans add US$28 million to what would have been the assessed project value for Achmmach 2.0 at today's tin price.

Despite the rework, the project remains on the edge of viability. Now, a drop of little more than 10% in the tin price would render the project worthless.

The company has not disclosed how sensitive its newly assessed value is to changes in its assumed discount rate. Nor has it proffered any rationale for choosing an unchanged 8% throughout the past three years in differing capital market circumstances.

The previously assumed cost of capital used to value the project was evidently too low. Otherwise, construction would have started. Capital for development opportunities in the sector has become tougher to get since 2013. The cost of high-risk capital has risen further over recent months.

Neglecting such changes risks promoting more false hopes that value accretive deals can be consummated when the project is exposed to real-world prices.

Achmmach 3.0 is a worthy attempt to dislodge the project from the 'phase one' value trap. The new Kasbah Resources investment proposition, based on the company's new disclosures, requires a US$64 million outlay to get back US$149 million over slightly more than 13 years.

A year earlier, the development plan called for a US$163 million outlay in exchange for US$522 million over 14 years.

The newly outlined value proposition implying a 10.1% average annual cash yield is hardly stunning and is considerably less attractive than the 15.4% anticipated in 2015 but is, presumably, more achievable. The cash yield on the older model would have been just 3% with current prices. ▼

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