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Gold good, but still risky

Red Mountain Mining has distinguished itself from other ASX-listed gold miners by acknowledging how sensitive its project value is to changes in the gold price.

[John Robertson*](#) | 07 Jul 2016 | 9:19 | [Feature](#)

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Red Mountain Mining is one of the few companies offering sensitivity analysis

Of 10 of the most recent reports by ASX-listed companies with gold resources, only one has information about valuation sensitivity to movements in the gold price where it is supposedly required by the JORC Code.

Discovering such a disconcertingly high incidence of non-compliance did not come from an attempt to show how flimsily policed the JORC Code has become. Seeing the extent of the failure to comply was incidental to finding a company to illustrate a point about valuation methodology.

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Hence the choice for this column of Red Mountain Mining, which released the results of a study into its Batangas gold project in the Philippines on June 15.

The seven-year Batangas project is expected to produce 116,000 ounces of gold and generate cash of A\$46 million (US\$35 million). Capitalised at around A\$5 million, Red Mountain Mining placed a value on the project of A\$33 million.

Disparities between project point valuations and company market values, invariably used as investment lures, hide the level of confidence behind the value assessment. The economic analysis in this case was prepared to an overall level of accuracy of plus or minus 25%.

Companies never offer valuation ranges based on the confidence levels attaching to their model inputs despite the JORC Code admonition that a report should contain "all the relevant information that investors and their professional advisers would reasonably require, and reasonably expect to find in the report, for the purpose of making a reasoned and balanced judgment".

Investors have three reasons to buy equity in a company engaged in gold mining or exploration.

Buying equity may be a substitute for a direct bullion holding wanted for its portfolio diversifying attributes. While this is the longest standing reason for buying gold equities, it has become less compelling since even the smallest personal investor is now able to cost effectively purchase bullion-backed securities.

An alternative reason is a desire for a leveraged exposure to an anticipated increase in the gold price. The quality of a company's mineral resource or its development potential may not matter greatly in selecting the company most leveraged to such a change.

The third reason for a gold equity investment is pursuit of a value proposition arising from development of a mineral discovery.

Directors seeking investors in this third category cannot possibly meet the requirement of the JORC Code if they fail to provide sensitivity analyses that permit investors to understand the likelihood of a company falling short of its value goal.

In this regard, it is not enough for directors to simply assert, as many do, that such an outcome is unlikely.

Variation in the gold price itself is one of the more important of the many ways a company can fail to meet its value potential.

Red Mountain Mining has estimated that a A\$100/oz reduction in the assumed gold price would reduce its assessed project value (in this instance before taxes and corporate expenses) from A\$33 million to A\$24 million.

One of the challenges for an investor confronted by the standard sensitivity analysis is to work out how it should impact an investment decision.

The preferred PortfolioDirect approach is to use the sensitivity analysis in a simple two step process.

The first step is to ask: "How much would the gold price have to change to eliminate the value proposition entirely?" In this case, the analysis presented by the company suggests that a A\$471/oz fall in the gold price would eliminate any value increment from development.

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That prompts the second question, namely: "How likely is such a fall?"

For Red Mountain Mining, the value eliminating fall would be equivalent to a 27% reduction in the US dollar denominated gold price.

The PortfolioDirect model, based on a statistical analysis of gold price returns between 1970 and 2015, suggests that the chance of a gold price variation of that size or larger over 12 months is 17%.

The lower the likelihood of such a price variation, the greater the confidence an investor could have that the company will reach its target value. This would also be a test of whether to accept the usually unsupported assertion that an investment is "compelling" or "robust", the epithets most frequently given to new projects for which funding is being sought.

Any company failing to provide the sensitivity analysis to make this calculation will prevent investors from doing what the JORC Code anticipates and the laws regulating financial advisers require, if they are to recommend such an investment.

Investors and their advisers could do the necessary modelling for themselves or pay researchers but the absence of the relevant information signals either arrogance or ignorance and, in either event, offers sufficient grounds to shun the offending company.

The rule of thumb applied within the PortfolioDirect analytical framework is to discard any investment in which a value eliminating gold price move has a higher probability than 25%.

Happily, the Red Mountain Mining outcome is within an acceptable range. Less happily, Red Mountain Mining has displayed all the leadership stability of a British political party in the last few days to highlight, too, how more than just the gold price is going to affect the investment outcome.

Whatever the attractiveness or shortcomings of Red Mountain Mining itself, the main message here is simple enough: companies ducking their reporting obligations prevent investors from making informed decisions and, in diverting scrutiny from their activities, do not deserve support.

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