Teach yourself how to build a Business Case for any industry incl Mining

2b Step1: What business entity do I evaluate?

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Spend only a few seconds/minutes on each page

This website contains opinions.

This website does not profess expertise in financing

It may have errors so always check your own work and have it audited by a competent person.

Now for the most important, most challenging and most rewarding activities:

Level 2: Using the 'workhorse' business model to fully evaluate and to understand the business/project.

Aspendale Beach – by Richard Newton

Inside Level 2 there usually are five steps …

Level 3: Decision making

Level 2: Evaluating the business/project

Level 1: Hands-on business modelling

- **Step 1: Decide which business entity is to be evaluated**
- **Step 2: Create the hands-on model**
- **Step 3: Compute the basket of powerful economic measures:** NPV, IRR, Payback, four cash streams, key drivers, break-evens, uncertainty, risk, optionality
- **Step 4: Assess alternatives, flexibility, options, risks, the business, the industry**

Step 5: Interact so the decision makers "have their eyes wide open"

Inside Level 2 there usually are five steps …

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- **Step 1: Decide which business entity is to be evaluated**

…hands-on model

…erful economic measures: NPV,
…rs, break-evens,

…risks, the business,

…eir eyes wide open"

So what entity do I evaluate?

If a business/project is owned 100% by one company and located in the same country then the entity should be relatively simple to value.

But what if it is located in another country, owned under a joint venture by three companies, each in different countries, with different rights and previous investments, with different financing and with very different local & international tax structures.

Well, here is an easy-to-understand way of modelling it all.

Let’s use an example to illustrate …

Say you are looking at building a project or buying an existing business: -

1. In a foreign country.
2. Your company will be taking a 70% share.
3. Two other companies reside in that country and will be taking up 20% and 10%
4. The other two companies will pay for the feasibility studies
5. Your company will help these two get financing to construct.
6. Once commercial operations start, the other two companies will pay your company a management fee of 2% of their sales revenue.
7. Your company will fund its share of construction through 80% equity and 20% debt.
8. Your company will own shares in the business and when it is profitable will get dividends repatriated across international borders.
9. The host country will impose international taxes on your company’s money flows and your company may face top-up taxes at home.

Where do you start?

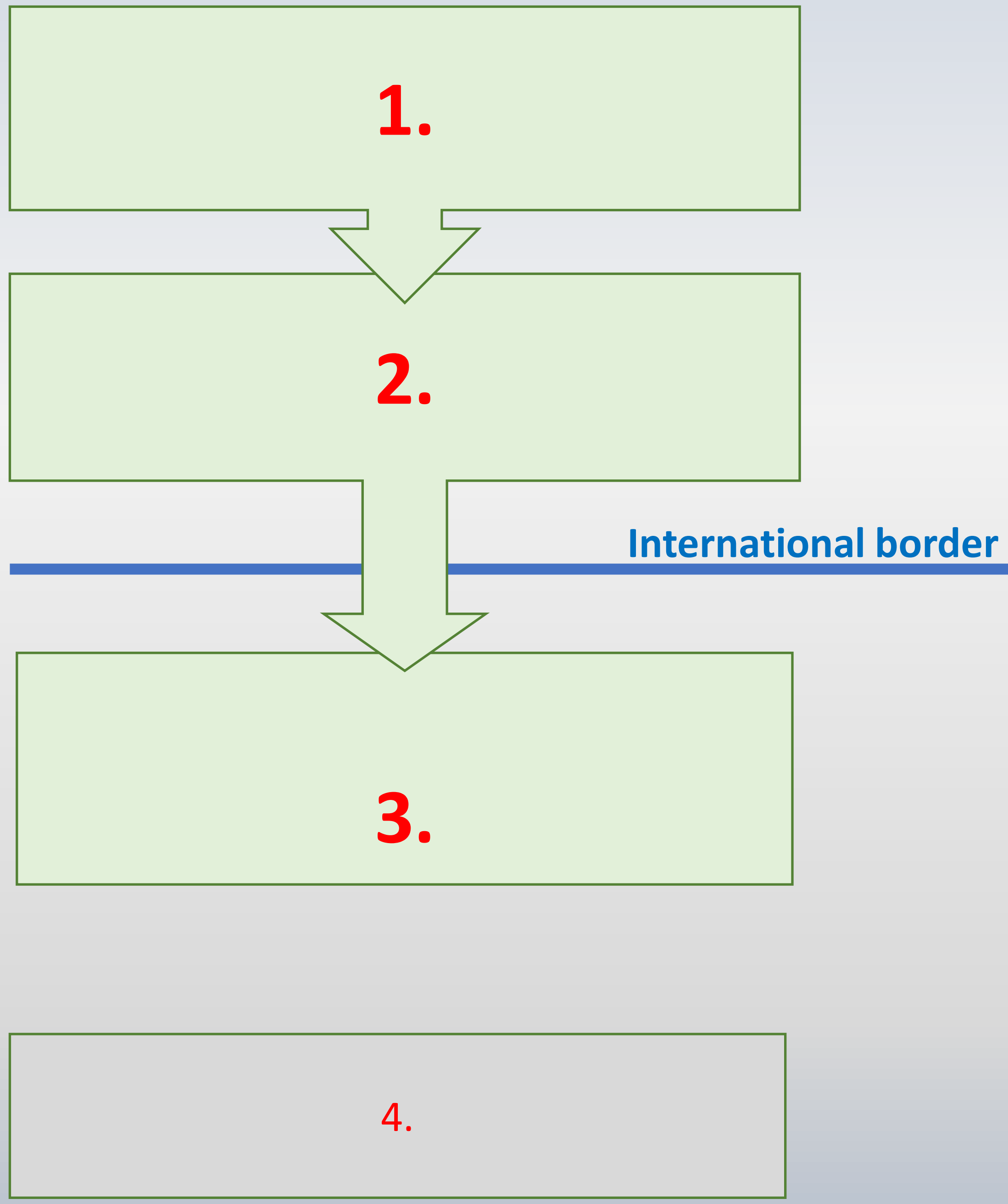
It really is quite simple …

Divide the project's world into two: -

The host country – for example Mongolia or Peru or Bosnia…

International border

The home country – for example Canada or Australia or UK …



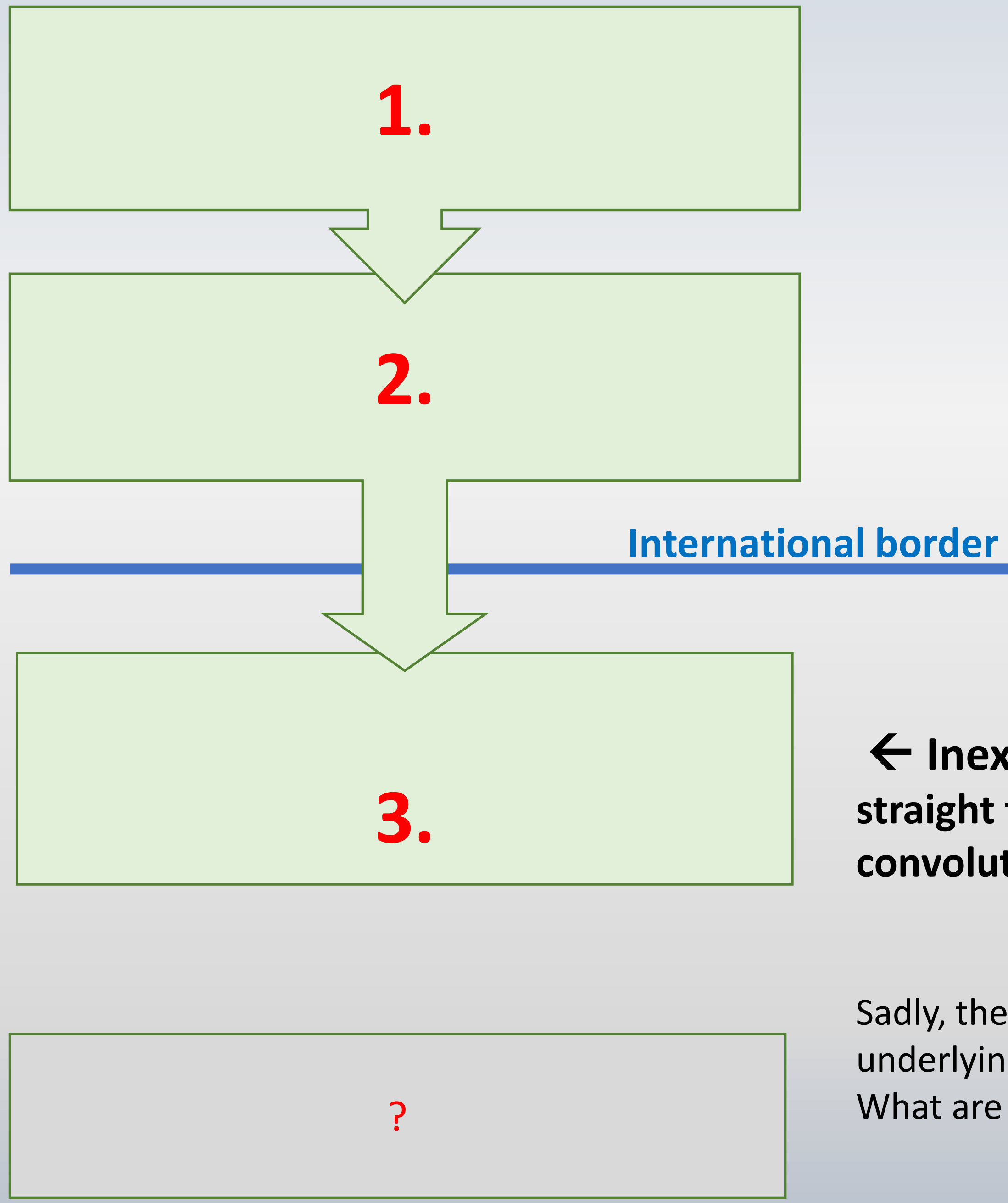
← Do a set of two valuations inside the host country

1. 100% of the underlying business
2. Your company's share

← Do a third valuation of its returns to its home country

3. Your company's share repatriated to your home country

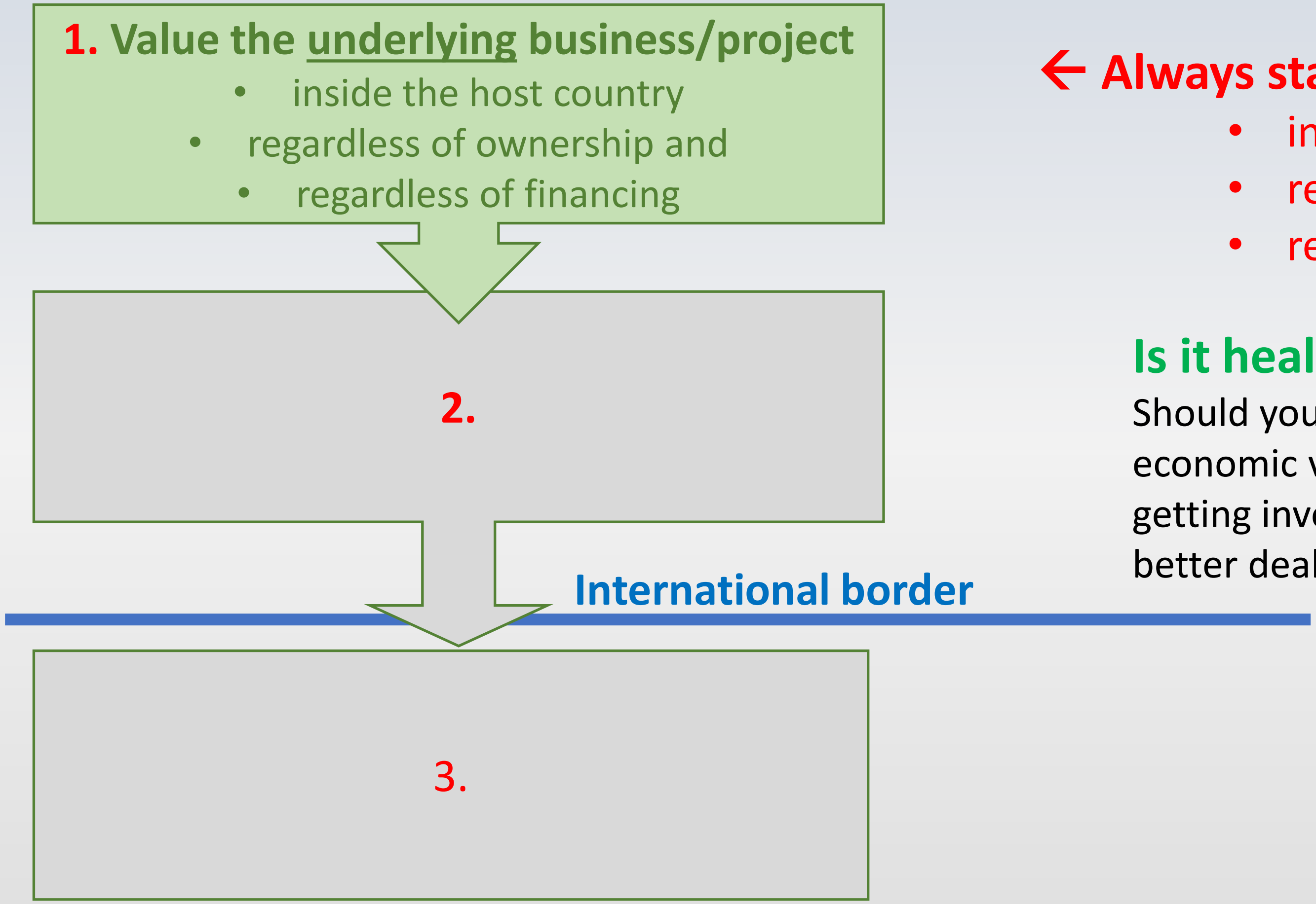
← If needed, get someone to help you add the financing & accounting



← **Inexperienced and naïve evaluation specialists might jump straight to this level. They might create a painfully sophisticated and convoluted model to pump out an NPV.**

"Wow! My model is a trophy of complexity!"

Sadly, they would not properly understand what is happening. How viable is the underlying business? Can it handle downturns? Can it be shaped a better way? What are the situations of the two other owners and other major stakeholders?



← **Always start by assessing the underlying business/project**

- in the host country
- regardless of ownership
- regardless of financing

Is it healthy and viable as a stand-alone entity?

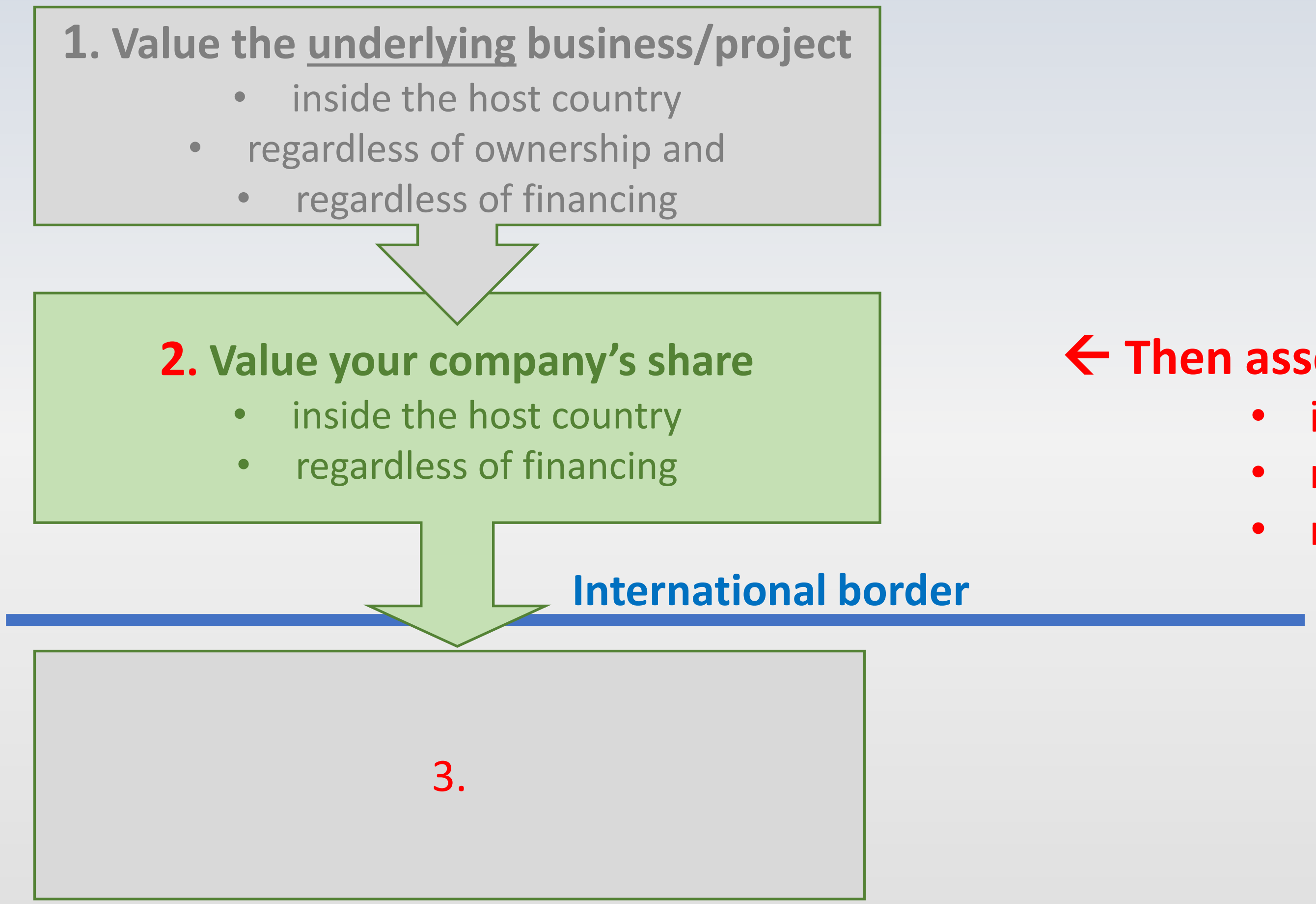
Should you get involved? If it looks viable then look deeper. If it lacks economic viability how will it survive? Usually there is little point in getting involved in a unhealthy business – even if you seem to be getting a better deal than the others.

1. Value the underlying business/project

- inside the host country
- regardless of ownership and
- regardless of financing

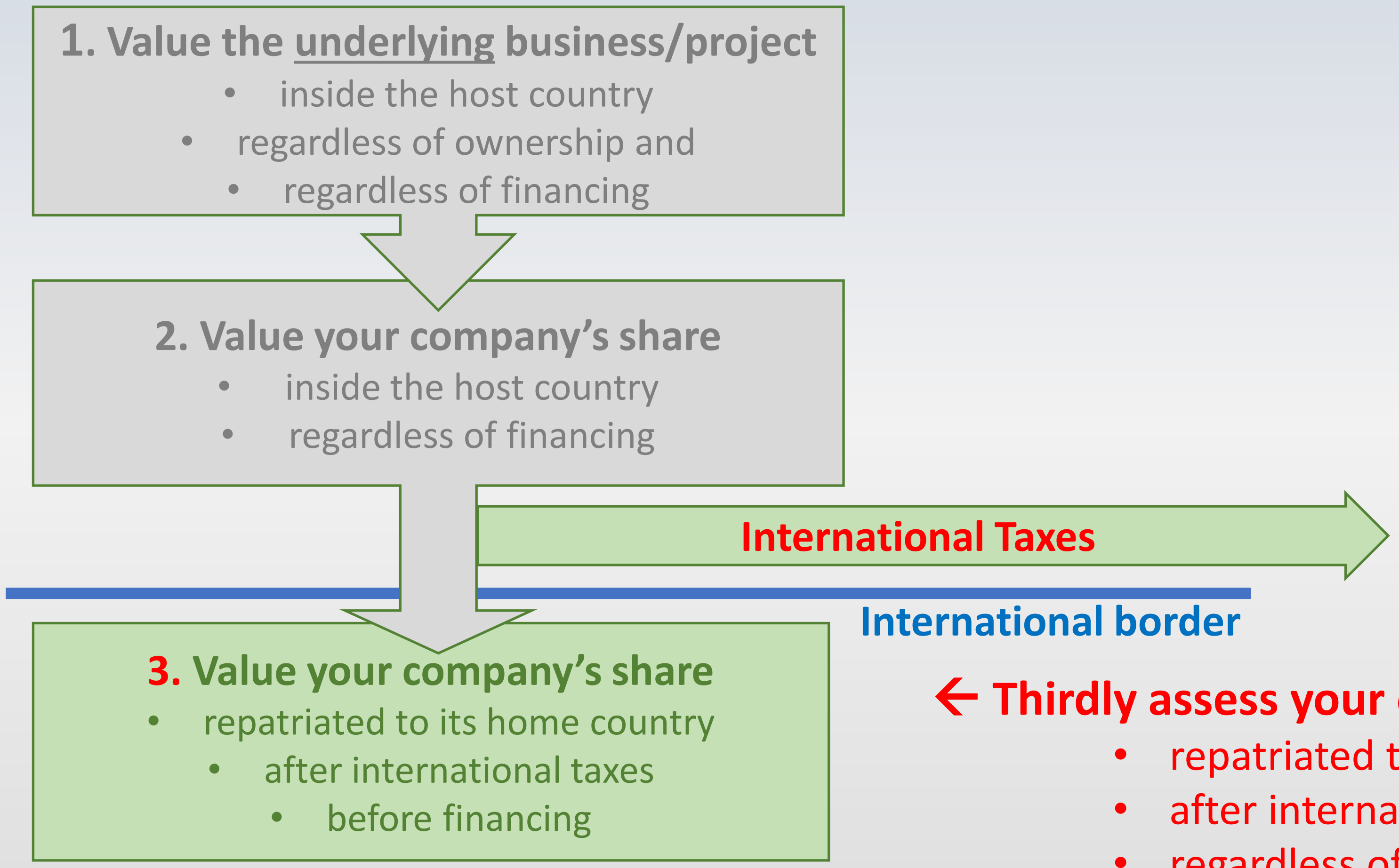
Assess the project across the full range of possibilities

1. Develop business strategies for the full range of possible markets
   - minimum, low, mid, high, maximum markets – prices, volumes and matching forex
   - recalculate production plans, sales plans for each market
   - do not have a base case and simply test it with different prices/exchange rates!
   - Do proper risk and uncertainty assessments of each workable alternative.
2. Assess the project's flexibility to expand, contract as the world economy evolves
3. Assess options for expansions and closure once the project is built.
4. Assess where each lies on the industry cost curve & its competitive advantages /weaknesses



← **Then assess your company's share of the business/project**

- in the host country
- regardless of ownership
- regardless of financing



← **Thirdly assess your company’s share of the business/project**

- repatriated to its home country
- after international taxes
- regardless of financing

1. Value the underlying business/project

- in the host country
- regardless of ownership and
- regardless of financing

2. Value your company's share

- in the host country
- regardless of financing

International Taxes

International border

3. Value your company's share

- repatriated to its home country
- After international taxes
- before financing

4. If required, **model the financing and the accounting.**

(Create a separate worksheet that receives data from above but does not send data back up.)

← Then if required, get someone to help you model the financing and accounting

1. Value the underlying business
- inside the host country
- regardless of ownership and
- regardless of financing

2. Value your company's share
- inside the host country
- regardless of financing

International Taxes

3. Value your company's share
- repatriated to its home country
- After international taxes
- before financing

4. If required, **model the financing and the accounting.**

Get a helicopter view of the business deal/project: -

Be very wary of deals where the underlying business/project has poor health but your company gets a good deal at the expense of other parties.

- In the long term the other parties probably will retreat and you may be left with a mess.
- One big mining company used to be so smug about doing deals like that; but the deals rarely flourished.

Most important: **You should this method to assess the position of all stakeholders in the business/project.**

Then you can understand their positions and perhaps negotiate a fairer deal: -

- Other owners
- National and regional governments
- Community groups
- Suppliers
- Customers
- Employees
- etc

What will each gain/lose from success/failure?

Looking in more detail …

Aspendale Beach – by Richard Newton

1. Value the underlying business/project

- inside the host country
- regardless of ownership and
- regardless of financing

I would start by modelling the underlying project/existing business as a stand alone entity inside the host country, paying host country taxes.

- I would not include any debt financing.
  Delete any interest payments incorporated in the construction costs.
  Do not include any interest payments on debt. (Some people call this a '100% equity valuation' – which is a misnomer)

- Do not worry about who owns what, who pays what operating expenses and who gets any surplus cash.
  Just see it all as flows of cash in and flows of cash out.

- Compute results under a few wide-ranging scenarios
  Start discussing with your colleagues/managers how the underlying project/ business behaves – negatives and positives.
  Does it look healthy in its own right? How does it handle adverse markets and can it exploit booming markets?
  Strengths and weaknesses?

Use this opportunity to influence colleagues and to become a key team member!

Help them learn the character of the underlying business/project – what are they actually getting into?
Mentor you team: don't buy 70% of an unhealthy business *unless everyone has* ***'eyes wide open'.***

2. Value your company’s share

- inside the host country
  - before financing

There looks to be two common ways of holding the 70% interest:

1. 70% equity
2. 70% joint venture

This website is not expert in company structures and financing but will give some thoughts.

2. Value your company's share
- inside the host country
  - before financing

1. 70% equity

My understanding is that if my company had a 70% equity share then it would hold 70% of the shares in the company that was building the project or buying the business. Let's call it "Company A".

My company would buy 70% of the shares of Company A for which it might pay $2 or $200 million.
My company would have to wait until the business became profitable (in accounting terms) and dividends were paid by Company A.
So my company would not be directly contributing 70% of the costs of constructions and would not directly receive 70% of surplus cash flow each year once operations and sales commenced.

The project/business would be run by "Company A", which would need to raise 100% of the cash to build the project or buy the business.
It would use its own mix of equity (contributed by shareholders like us) and debt (from finance companies, associates, etc).
Company A would manage the project/business from Day 1 until closure.
Each year any surplus cash flow in Company A would be used to pay interest, reduce its debt, expand business, … and eventually pay dividends to its shareholders.

Being 70% shareholder my company probably would nominate the majority of directors of Company A, help it obtain debt, perhaps provide senior management and special advice.
If Company A used say 80% equity to fund construction (or purchase) then my company probably would contribute 70% of that 80%.
My company should eventually receive 70% of the dividends paid by Company A inside the host country.
My company would then have to decide what to do with the dividends received inside the host country – perhaps repatriate and pay international taxes.

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2. Value your company's share
- inside the host country
  - before financing

1. 70% of a Joint Venture

My understanding is that a 70% interest in an unincorporated joint venture would be a lot simpler.

My company or its subsidiary would hold a stand-alone 70% slice of the project or existing business.

It would be as though my company had its own wholly owned business that is 70% the size of the underlying business.
My company/subsidiary would directly contribute 70% of construction costs.
Through its life my company would pay 70% of capital costs, 70% of operating costs,
My company would take 70% of each product and sell it to its own customers (who might be different to the other shareholders' customers.
My company would negotiate its own sales and receive its own revenue stream.
My company would pay its own tax in the host country. ← most importantly, it can take advantage of any legitimate benefits it may have in that country which the other companies may not have.
My company would pay any extra taxes getting any cash out of the host country and pay any top-up taxes back in its own country.
My company would set up its own equity/debt financing.

The 20% and 10% joint venturers would be completely independent.

They would have their own sales contracts, revenue streams, opex and capex payments, financing and tax returns.

My understanding is that joint venturers are not 'partners' but '**participants**'.

This joint venture interest would not have the complications and tardiness of working through dividends from Company A

This website is not expert in company structures and financing

2. Value your company's share

- inside the host country
- before financing

(**+ assess the situation of co-owners and other key stakeholders**)

Joint Venture: Valuation **'2.'** might be straight forward in a joint venture. I would add a worksheet to the right-hand end of my core model of 'Valuation **1:** The underlying business', in which I would compute my company's cashflows inside the host country. This might require relatively few rows.
If there were material side deals between the various owners in a joint venture - as in the example at the beginning of this module – then I may have to make extensive adjustments to capex and opex and hence need to recalculate tax for my company.

Equity: If my company owns 70% of the shares in Company A, then the computations of cash paid in as equity and cash eventually received as dividends (before financing) are likely to be long and detailed because they all go in and out through Company A. I may need the help of an experienced, pragmatic Accountant.

Understand your co-owners business

Now repeat this valuation for each of the co-owners so you know exactly how their holdings would shape up. Are they getting a better deal? Are they getting an unattractive deal or is this a win-win? Is it likely to be a stable relationship into the long term?

Understand other key stakeholders

It should be fast and worthwhile to model what the other key stakeholders are likely to receive. When negotiating, you will understand what each is likely to receive under various scenarios. You will be able to discuss the business/project with knowledge and wisdom.

Testing: I would test the valuations across a full range of bad and good scenarios.

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3. Value your company's share

- inside its home country
    - before financing

This third step will of course depend on whether the ownership is 100%, a joint venture or a shareholding.
The main issue will be how much cash is lost to international taxes – during investing and on repatriating.
There can be lots of less obvious, indirect taxes. (research on the internet – esp in the big accounting companies websites)
This might neatly fit on the extra worksheet you create for Valuation 2.

As in all evaluation work you need to keep the big picture in mind. It may be sensible to approximate outcomes so as to eliminate hundreds of rows of computation if it is agreed with tax experts and accountants that the result will satisfactory for decision making.
(You are not computing the Company's tax returns nor its Accounts, but you are creating its business profile.)

4. Then if required, **model the financing and the accounting.**

When the financing is needed, I usually add an extra worksheet to the back of my model. I try to keep computations in perspective and do not get bogged down in infinite detail to compute exact drawdowns, precise interest, exact repayments, etc. Instead I use approximations that match the accuracy of the key assumptions going into the revenue, opex and capex.
If an accounting worksheet is needed then I try to get a practical accountant to set up the calculations.

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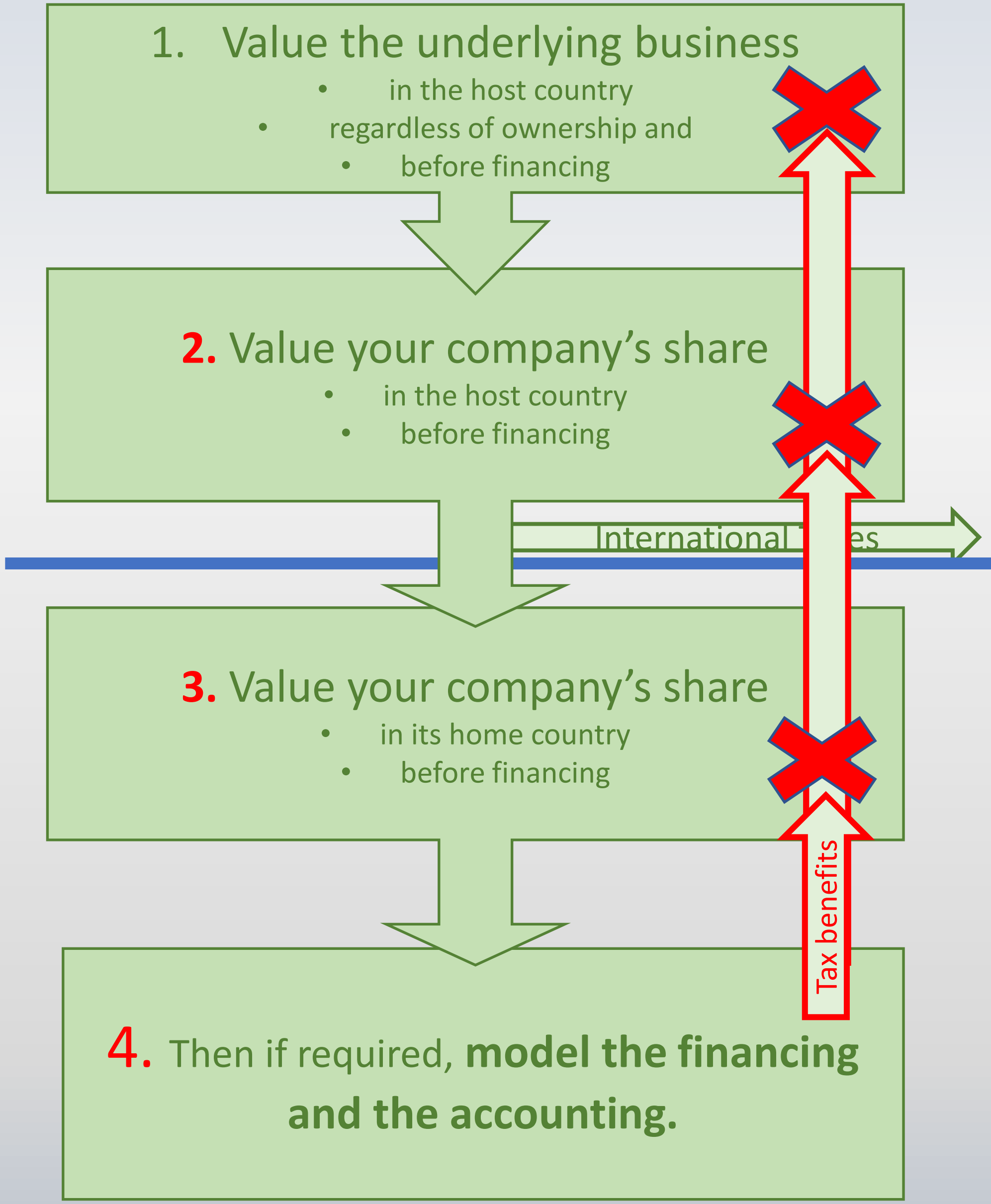

Most Importantly: Any tax benefits from financing should not flow back up to the valuations!

Remember: *If people tell you that the NPV will increase significantly by employing debt funding then they possibly do not understand financial theory. As debt increases then perhaps the discount rate should increase to largely offset the tax benefit.*

Inside Level 2 there usually are five steps …

Level 3: Decision making

Level 2: Evaluating the business/project

Level 1: Hands-on business modelling

Step 2: is covered on this website by the modules in Level 1 →

Next we will work through Step 3 →

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You can make economic evaluation the best job of all!
End of Module 2b
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