Case Study

An African Gold Refinery Company

Service(s) offered: **Due Diligence & Valuations**

Sector/Industry: **Materials**

Valuation of a Gold Refining Business for a Strategic Stake Sale by a Venture Capital Fund

Our client is a Dubai-based venture capital fund (Client) that mainly invests in the commodities business. The Client and another investor have been working with the Government of Kenya to set up gold refinery operations (Company) in Kenya. The Company had received the requisite licenses from the Kenyan Ministry of Mining. After which, they started setting up a state-of-the-art gold refining facility and signed off-take agreements for procuring ore from gold mines. They were in the process of signing a supply agreement with a GCC-based commodity player.

The Client held a majority stake in the business and was planning to sell a partial stake in the Company to the GCC-based commodity player. The Client had prepared a detailed valuation of the Company and engaged Nexdigm to review the valuation of the Company.

Approach

Our approach was divided into the following phases:

1. Understanding the Business and Industry Dynamics
2. Evaluation of Valuation Approaches / Methodologies
3. Review of Valuation Approaches/Methodologies
4. Valuation of the Company

Phase I - Understanding the Business and Industry Dynamics

Discussions with the Client coupled with analyzing the business model and operations gave us valuable insights into the Company's business plans. We understood how the Company planned to source the gold from small- and medium-scale miners via long-term contracts. The Company also had a relationship with a trader in the GCC region to monetize the gold output produced.

Nexdigm referred to proprietary databases and research reports to better understand the sector. We then adopted a top-down approach in order to understand the gold mining sector. Knowledge of the Company's business plan helped us narrow down our analysis of the sector and identify peers that operated with a similar business model.

Phase II - Evaluation of Valuation Approaches / Methodologies

We reviewed the business and the valuation model for mathematical and logical errors and recommended changes concerning:

- Formula for the cost of goods sold
- Depreciation on Property, Plant, and Equipment
- Cash flows considered to arrive at the terminal value
- Discounting period considered

These changes were made in line with the industry best practices. The cumulative impact of these changes was an increase of approximately 28% in the valuation. This impact on the valuation was without making any changes to the perpetual growth rate and a weighted average cost of capital as considered by the Client.

We also corrected the forecasted valuation. The Client had considered the discrete period cash flow method as well in the forecasted valuation. However, forecasted valuations should only consider the terminal value and the cash balance at the end of the discrete period. This change resulted in a decrease in the forecasted valuation by 31%.

Phase III - Review of Valuation Approaches/ Methodologies

Discounted Cash Flow (DCF) Method

Since the Company was starting with its business operations, its current performance wasn't an adequate measure of the business's value. The Company was setting up gold refining operations in an untested geography, where the risks, rewards, benefits, and challenges would have been specific to the Company. Considering the same, the Client and the management of the Company had prepared a detailed business plan after consultations and discussions with local authorities, suppliers, vendors, logistic partners, production managers, and market participants, to realistically estimate the future operations of the business. Based on the information and facts presented to the team, we concluded that using the Discounted Cash Flow method was the most suitable approach to value the Company.

Comparable Companies Multiple (CCM) Method

The Client had already identified publicly traded companies used to arrive at a multiple-based valuation. On further analysis, we believed that the peers specified by the Client were mainly into mining operations, whereas the Company was into refining gold. This vertical integration of operations by the peers would add more value to their business and hence, were not comparable to the Company. We also did an independent study to identify comparable companies. However, we concluded that there were no similar companies with operations and business models identical to that of the Company.

Phase IV - Valuation of the Company

As mentioned above, we tested the financial model for mathematical and logical checks and made the necessary changes in line with best practices. Since our scope was merely limited to a review, we did not comment on the achievability and reasonableness of the assumptions used in amalgamating the business plan. Still, we conducted and presented s sensitivity analysis for the key variables.

For the purpose of DCF, we arrived at the discounting rate by determining the cost of equity for the Kenyan market. We also determined the cost of equity for the US market and then added a relevant premium to reflect the risk in Kenya. This gave us a range for the discounting rate to be used. The higher discounting rate was then tapered down linearly over the projected period to capture the higher risk in the initial periods.

Based on the above method, we arrived at the current and forecasted value of the Company.

Furthermore, we also conducted a sensitivity analysis on both the current and forecasted valuation for various inputs such as the Company's purchase price and selling price of gold capacity utilization.

Impact

We presented our findings and the valuation conclusion to the Client in a detailed valuation report, which helped the Client negotiate with its potential investors.

For more information on this case study, please write to us at:

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You can also visit our website to know how our services resulted in tangible business benefits:

www.nexdigm.com