## THE BORROWER

by
*J. C. Simkiss*
Treasurer, Conzinc Riotinto of Australia Limited

My role in the panel today is to talk about offshore financing from the point of view of the borrower:

I will structure my discussion under four headings —

Advantages
Disadvantages
Documentation
Taxation.

*Advantages*

The two major advantages of offshore financing are firstly, the size of the international financial market and the consequent availability of funds for major resource project financing.

Secondly, the ability to borrow US dollars — (whether domestic US dollars or Eurodollars) — which is the natural currency for financing projects which sell their products in international markets. Prices in these markets generally have as their base the sole international reserve currency — the US dollar.

I have emphasised the ability to borrow US dollars. It is obviously an advantage of offshore funding to borrow in any currency in which one makes an overseas investment, e.g. to borrow Malaysian dollars to finance a new investment in Malaysia. However, we are mostly concerned with borrowing $US.

While the Australian capital market has increased its capability to undertake relatively large financing in Australian dollars, major resource projects require access to international financings to be able to proceed. This will certainly be true for projects such as the North West Shelf — with a total project cost of $A3 billion — but it is also true even for projects such as the Hamersley concentrator — $350 million of total expenditure, partly financed by an $US80 million Eurobond issue early in 1977 and part to be financed by bank loans of $US210 million.

While the Hamersley build up of internal cash flow in 1976 and 1977 can be thought of as substantial domestic funding for the project, the recent conversion offer of debentures to existing Australian debenture holders was only taken up as to about 25% — even though interest rates offered were 10.5% for 10 years. This example may be a little unfair since it was only a conversion offer to existing debenture holders with limited publicity; nevertheless the example is valid to demonstrate the problem of funding sizeable projects in the Australian capital market.

The size of the offshore market also manifests itself in a number of other benefits to borrowers — particularly in generally lower interest rates than in the Australian market, competitive lending spreads, innovative financing techniques designed to meet the needs of particular projects and borrowers and the availability of specific attractive facilities, which were brought out in Bill Bonds' paper, such as Bankers Acceptance facilities and low-interest supplier credits.

Comparisons of interest rates of course suffer from the respective economic cycles being out of phase. In comparing current Australian and international interest rates, currently local corporate borrowing rates are still above domestic US rates despite US interest rates having risen right through 1978 while local rates have been falling during that time.

In respect of the second advantage, the ability to borrow US dollars, it is necessary to recognise the extent to which our export trade, particularly for the mineral industry, is carried out in $US. For example, as an approximation, some 85% of CRA Group sales would be written directly in $US, or prices with an underlying base in $US.

In these circumstances it is sound and natural to borrow in the currency in which project revenues arise, or in the case of an offshore investment, the currency in which the project assets are invested.

*Disadvantages*

The major disadvantage for Australian companies in borrowing other than $A is in the exposure to currency fluctuation where there are no foreign currency export earnings, or alternatively where offshore borrowings are undertaken in currencies other than those in which exports are denominated.

I have referred to the position for companies; the position for governments is somewhat different. The Federal Government has the ability to limit its currency exposure by holding its borrowings as offshore cash reserves, at least as long as its reserves last. However, State Governments will have a particular problem since they have no foreign currency earnings except to the extent to which royalities from projects are related to US dollar sales. They will have a problem of currency exposure in offshore funding for infrastructure projects. However, Governments tend to have shorter management lives than companies, and they are not required to account to shareholders for profits and losses!

It is easy enough to argue that the cost of currency exposure is offset by low interest rates in hard currencies. However the important point to recognise is the borrowing without foreign currency exports or borrowing in a currency other than that in which exports arise is speculation.

The second disadvantage of offshore borrowing is the extent of fluctuation in borrowing conditions — both the availability of funds, and interest rates, compared to the general stability of rates in the domestic market. Industry in Australia is used to borrow term bank loans at fixed interest rates, compared to the variable rates paid for international bank loans. These variable rates can fluctuate sharply.

The third disadvantage of offshore borrowing is that it can be subject to controls from time to time by the Federal Government. Currently it is Government policy to encourage overseas borrowing to assist the balance of payments — by the Government, States and companies, but it is not that long since the VDR mechanism discouraged such borrowing. Interestingly the possibility of impending controls is sometimes pointed out as an advantage of offshore funding e.g. in the US at the moment, US companies are being encouraged to undertake offshore funding because of the possibility of borrowing controls by the Federal Government.

*Documentation*

Turning to documentation, I think it is fair to say that loan documentation can be simple in both domestic and offshore borrowing, and can be complicated in both. However, complications normally arise from the individual project or security structure rather than from the source of borrowing.

One should also distinguish between bank borrowing, and institutional borrowing on the Eurobond or US markets. A public US debenture raising requires SEC filing, and rating by one of the rating agencies — which is also required for financing in the US Commercial paper market.

These add complexity and time in arranging presentations. This is also true for institutional borrowing. Bank borrowing is obviously simpler, but for shorter term lending and variable interest rates. On the other hand, there has not been the ability to undertake a fixed rate Eurobond issue for virtually the whole of 1978.

Generally, offshore bank credit syndications will have wider syndicate membership than for local borrowing but this does not usually complicate negotiation for the borrower because of the role played by the lead bank.

However, it is certainly true that as project size increases, and particularly for joint venture projects, putting together the financing package from the various funding sources is a significant task. In particular determining and documenting the security structure as between different ranking lenders and so as to protect other assets of the borrowers can be a critical feature of fund availability and therefore of a viable project.

In practice borrowers should keep their draft loan documentation and company information or offering circulars up to date so as to be able to move quickly should an attractive borrowing opportunity arise. Also in practice, one finds that Government regulations in respect of stamp duty and withholding tax can have a significant effect on the time to negotiate and document a loan.

*Tax*

The two distinctive features of tax on offshore financing as compared to domestic fund raising are the withholding tax on interest and the non-taxable nature of losses and gains from currency variations.

Withholding tax of course applies to borrowings by foreign controlled companies or, put the other way, it does not apply to essentially Australian controlled companies. Currently a different definition of control applies for tax to that in the new Australianisation guidelines.

The withholding tax on interest is just not a sensible tax, since it distorts financial markets as between company and government borrowing and as between public and private borrowings i.e. it is levied on bank borrowing but not on public borrowing e.g. Eurobond issues. Where levied, it is basically passed back to the borrowing company.

We have made a number of representations to the Government to remove the tax and are hopeful that these will eventually succeed. In the meantime the tax has the effect of raising effective international interest rates and restricting lending competition since borrowers who are subject to tax tend to look for banks which can absorb Australian withholding tax because of their international tax structure. This narrows the lending field.

In respect of gains and losses from currency fluctuations on loan repayments, these are treated as capital transactions under Australian tax law. In comparing offshore borrowing costs to domestic interest rates, one therefore has to recognise that interest rate differentials are net of tax but that losses arising from borrowing low interest funds in hard currencies are not tax deductible. Again while one appreciates the tax background to the capital versus operating definition applied to normal loans this is not really accepted as a valid interpretation when applied to foreign borrowing. Again representations have been made although one must be less optimistic of change in this area. Nevertheless other countries such as New Zealand do allow treatment of gains and losses as operating items for taxation.

*Conclusion*

As a major mining company, while we continue to seek the development of the Australian capital market, we have long accepted the necessity and the attractions of offshore funding for projects selling in export markets. We have actively encouraged the Australian trading banks to play an aggressive role in provision of offshore funds to such projects, and at the same time we have also encouraged international banks to increase their presence in Australia. We respect the service we have had over a long period from major international banks. We encourage new banks to be innovative and understand our business and our particular requirements in order for them to obtain new business. Competition in lending is good for Australia, and for borrowers.

## BOOK REVIEW

### EASY READING ON INTERNATIONAL CORPORATE FINANCE

**International Dimensions of Corporate Finance** by David A. Ricks,
Prentice-Hall, Englewood Cliffs, New Jersey, 1978. Pp. 143. $A9.50.

David Ricks of the Faculty of Finance at Ohio State University has produced an interesting, useful text on the international aspects of corporate financing. His objective is to provide a text which supplements the material available in other, traditional corporate finance texts, in order to provide the reader with a broader knowledge of the financial problems and solutions of a firm operating internationally. The book does not give a complete coverage of international finance for it discusses only those aspects of international finance which pertain directly to corporate finance. Important features are the sections on taxes, working capital management, capital budgeting and controls, financing business operations, and mergers and acquisitions, and the bibliographies supplementing the 14 chapters. Although a multitude of subjects, such as development banks and exchange rate risks, are discussed, the treatment in all cases is brief — often only a page or so — thus making the book delightfully concise and easy to read. But there will be some readers who will find such treatment too brief for their requirements. This paperback volume is a new addition to the excellent Prentice-Hall Foundations of Finance Series.

E. F. GILLIN