CONSIDERATIONS IN GOLD MINE PROJECT FINANCING

by

Michael Street

Manager, Advisory Services, Capel Court Corporation

During late February this year at the time of an OPEC Conference, the price of gold dropped US$100 an ounce in 10 trading days, which represented a 20 per cent fall in value.

That highlights the problems faced not only by a company assessing whether it should proceed to develop a gold mine but also by bankers as to whether and if so, how much they should lend to such a project.

EFFECTS ON GOLD PRICE

In the real world there is no such thing as a true demand curve and a true supply curve for gold. There does appear, however, to be a natural correlation between oil and gold in that when oil prices decline, that that arguably is generally good for the world economy which in turn has a detrimental effect on gold prices. The Soviet Union is also a constant influence in that it is one of the ways they buy hard currency.

Politics in fact is the critical element; in times of political turmoil flight to other currencies in search of safe havens can see such funds frozen, therefore gold has been the traditional escape route.

Apart from straight debt lent to companies developing a gold mine which are more likely to be companies with an existing cash flow and which need a small amount of top-up finance, potential borrowers should investigate the equity markets, the possibility of borrowing gold, and issuing fixed coupons with a commodity kicker element.

EQUITY

The public is likely to remain a major contributor of new funds to the gold mining industry by way of flotation of new companies, rights issues and the placement of new shares.

The flotation of a new company by way of public prospectus has become a time consuming and expensive procedure. It takes approximately 5 months to issue a prospectus and the attendant costs make it impractical to proceed with an issue or less than $2 million.

The time delays make this course of action rather uncertain in that there can be no guarantee that the marketplace will be suitable to such an issue that far ahead.

A rights issue by an existing company is also a time consuming process in that under Stock Exchange regulations the issue will take 9 weeks and any extension of time for the benefit of overseas shareholders makes this period even longer. With these time constraints in mind, the new issue will be pitched at a relatively low price because of the possibility of adverse share price movements in the meantime.

During a firm market, it is possible for publicly listed companies to place stock privately instead of being offered to the public generally. This method of raising funds at close to the current market price is much cheaper than issuing subject to a prospectus, but it is only possible if the issue can be absorbed by known individuals or institutions.

BORROWING GOLD

Gold has been borrowed by suitably credit worthy customers from banks specialising in bullion for some time now.

Because the rates of interest charged on such loans are low compared with the cost of money, industrial customers who require a stock of gold for manufacturing purposes often find such borrowing advantageous, particularly where the gold price is static or falling.

Traditionally the amounts borrowed have been in the range 5,000 ounces to 100,000 ounces with loans for periods of one to six months. Interest rates are at a minimum of 1 per cent per annum with increases above that dependant on market conditions and the length of the commitment period.

This concept has been adapted as of late to provide finance for the development of gold mines out to as far as 4 years. In essence the developer would borrow the stock of gold required for spot sale based on the London fixing thereby generating the cash to be used to finance the appropriate percentage of the project.

The sale of gold could either be made pursuant to an arrangement where the gold loan facility was held available by the bank until such time as the developer deemed propitious to sell. Alternatively, advance payments could be made at different times as funds are required by selling the gold at the then ruling market prices. Gold would be sold in total up to an aggregate of the agreed limit.

Repayment of the facility could be effected either by the developer:

- physically delivering the gold "Loco London" or such other location, or form of gold as may be mutually agreed. For instance the developer might deliver the gold as unrefined bullion to an approved Australian refinery with actual delivery to the bank occurring at this point, the gold content being held to the bank's account by the refinery.
- alternatively delivery obligations could be met by using the proceeds of gold sold pursuant to contracts with third parties, in order to purchase spot gold on the international market for subsequent transfer to the lender.

The principal advantages of the gold loan are

(i) the interest rates are minimal in comparison with traditional sources of debt finance.
Interest is calculated in fine ounces of gold and paid in US dollars at the end of each 3 or 6 month interest period and calculated by reference to the average fixing price in London for that particular interest period. Therefore the interest burden will fluctuate, in monetary terms, with movements in the gold price.

(ii) it effectively hedges the output against price movements such that gold production can be sold at a known margin above the break-even price of the mine, and

(iii) by being entitled to meet gold delivery requirements by alternative means, the miner retains flexibility in relation to timing and ultimate marketing of gold output.

Borrowers should be aware that the company will have a liability to repay at maturity expressed in gold terms: it is therefore a function of the price of gold at that time. Therefore problems will arise if the project is substantially delayed or if there is a shortfall in gold output from the mine.

With the above in mind, unless the borrower has substantial cash flow from other operations, the amount of gold borrowed should not be more than for a limited proportion of the projected output.

From the banker's viewpoint, an increase in the monetary value of the loan as a result of a sustained upwards movement in the price of gold during the life of the loan will increase the credit exposure. The negotiated facility would incorporate within it a price exposure limit which would cover a substantial rise in the price of gold prior to delivery.

Subsequent price increases beyond that limit would be required to be covered by way of interest bearing cash deposits or letters of credit.

As deliveries of gold take place within the terms of the negotiated facility the price exposure limit per ounce of gold under the terms of the original facility would increase.

It is prudent for the borrower to have lines of credit available so that the company could purchase gold in the market in order to repay all or part of the gold loan thus limiting the potential increaase in the company's liability as a result of upward movements in gold.

Gold mining developments in this country might typically cost up to $40million in today's dollars. It is conceivable that the larger producers with other sources of substantial cash flow will opt to take the "loan" as a corporate credit and not project finance, because they may feel it is too small to warrant the extra time and costs involved in more complex documentation. Of far greater challenge are the smaller companies that may have little or no other cash flow and where such borrowings will invariably have the effect of a project finance, albeit with a volatile product.

Price and its volatility will be the major risk that the lenders will have to learn to live with. As the market risk per se is of little concern, the other risks for lenders to assess in these project, and quasi project, facilities for the smaller borrowers are the adequacy of reserves and whether the facilities are capable of operating at full or near full specifications.

As far as price is concerned, should it escalate and the developer have a successful mine then despite the escalating credit risk, the debt to lenders will be more easily repaid. On the other hand when the price of gold falls the monetary equivalent due to the banks will have fallen proportionately. However problems could arise for banks when the price of gold falls below the operating costs for sustained periods. Steps however can be taken by banks to mitigate this event.

COMMODITY LINKED SECURITIES

There have been a number of issues overseas of securities offering returns indexed to the current market value of commodities. Those issues were placed successfully and in case of debt issues often at a coupon rate well below then current market levels.

Such issues provide an opportunity for commodity producing issuers and international commodity organisations to borrow at below market interest rates, whilst at the same time providing an opportunity for investors to speculate on commodities for very long terms, to earn interest and avoid carrying costs.

With redemption and distribution obligations indexed to future value and bearing in mind the substantial price fluctuations, the actual ownership and possession of the physical commodity is the only long term guarantee that an issuer will have resources to fund this commitment.

So long as the availability of the commodity is assured, credit risk is substantially reduced, regardless of the magnitude of the rise in prices. However, most commodity indexed issues have included convenants to maintain commodity reserves on hand to fund interest and redemption obligations.

Potential problems can still arise of course as witnessed in June 1982 when the Sunshine Mining Company announced it had plans to shut down its principal mine in Idaho because production costs exceeded the market value of silver. Were this mine to be closed, one of the main security covenants, (to grant the trustee an interest in the mine's annual production to cover bondholders entitlements) would be useless until the mine was reopened.

Failure by the issuer to maintain the commodity reserves or any material act of non co-operation with the trustee becomes an event of default thereby triggering premature redemption and depriving bondholders of their potential benefits. This brings into question the bona fides of issuers in a sustained bull market where they may have an incentive to default.

Companies don't like assigning an option on profits that theoretically belongs to shareholders, especially when granted at bargain prices. However as an attraction they are medium to long term instruments and at concessional rates. For institutions on the other hand, they are interest bearing, have the security of tangible assets, are arguably an inflation hedge, provide a chance for a large capital gain and a hedge against an Australian dollar depreciation.

Unless inflation returns with a vengeance, these instruments will probably be confined to the weaker credits and the small high risk growth companies. In other words their growth will depend on who is doing the borrowing and the state of the credit markets at the time of borrowing.

HEDGING

The main purpose of hedging is to reduce the risk arising from adverse price movements. The costs of production of the miner are basically unalterable and therefore when the price reaches a satisfactory level, the miner may endeavour to fix it for a substantial portion of his forward commitments.

The impact of price changes is relatively more significant to mining than to most other industries as there inevitably tends to be a greater difference between current operating costs and revenue in the mining industry. Also there is the necessity to repay heavy capital costs inside a debt repayment schedule which would keep pressure on to produce at full capacity even though prices are unprofitable, so long as the operating cash flow is positive.

Facilities can be offered to producers to sell gold for forward delivery, hedging gold that is held in stock or in the process of being mined, thereby enabling producers to sell at what they consider to be attractive prices.

The price at which the forward sale is made would be a premium over the then current spot price, the premium being related to interest rates prevailing in the Euro-markets at that time. The facilities provide for producers to buy back their forward commitment at their option.

Forward sales facilities usually allow gold to be sold up to six months in advance of the proposed delivery date for gold. However, if required, sales could be arranged for up to two years forward.

The facility can be used even when gold production is already sold under long term contract. In such a case a buy back arrangement allows the producer to repurchase his forward commitment at the time he receives settlement from his sales contract.

The forward facility outlined has certain advantages over dealing in futures markets, the main ones in that

- there are no original margin requirements;
- if prices rise there is no obligation to put up additional non-interest bearing variation margins. Were there to be a major rise in the spot price, letters of credit might be called for to cover an agreed amount of the excess of the then current spot price over the forward price.

Being negotiated in conjunction with some forward sales facilities are provisions for a floor price mechanism. Under this method the producer is guaranteed that for a stipulated maximum percentage of production that he will receive a guaranteed minimum price. A number of factors would determine whether and to what extent a premium would be payable for the floor price option, including the amount under floor price as a percentage of the total facility, the level for the floor price below the spot price basis established for forward sales and the length of time outstanding.

Another quasi commodity kicker method of financing which is currently being discussed is an adaptation of put options. In essence the producer is guaranteed a certain minimum price for a stipulated quantity of gold above his operating break-even cost in return for which the producer passes on a percentage of any increase above a negotiated gold price level.

The most important factor influencing the decision to buy or sell an option is the price. This premium will vary according to the length of the option, the price of the gold and the anticipated movements in price.

The question mark on the use of options as a financing tool for the development of gold mines, is whether that particular option market can handle the possible large volumes and for periods out as far as four years. In

Australia, equity issues will remain a significant source of finance, but more will be heard of gold loans and also the longer term commodity linked raisings particularly where the dedication percentages dictate longer facilities and where the producer does not wish to effectively hedge such a large percentage of his annual production.

BOOK REVIEW

A GUIDE TO THE FINANCIAL MARKETS

by

Charles R. Geisst

This book is aimed at the general reader rather than the specialist.

The author describes three 'capital' markets — stock, money and bond — and three 'hedging' markets — commodity futures, foreign exchange and options with particular reference to Wall Street and London.

The author is well qualified with academic and market experience in both countries. He acknowledges the basic nature of his descriptions and that a prime target is the introductory level reader. The writing style and exposition generally are good.

This, as is the English style, is a mercifully slim investment volume but certainly too limited in scope for many JASSA readers. This book is *not* the answer to those who have discovered international investment and are troubled by different systems, terminology etc.

The author emphasises that this is not a 'how to' book. Although the jacket note says that the book is written from the investor's point of view, this doesn't really seem to be the author's position. An investment perspective would have called for some mention of collectables and a discussion of commodities as investments outside the futures context.

The book is already looking dated in some areas — there is no mention of share price index futures, for example.

A Guide to the Financial Markets could have some merit as an introductory text but it would, I believe, fail to catch the imagination of the general reader. For those more experienced in investment matters it offers little and has no attraction as a reference work.

A.R. Taylor

This publication (1982) is available from The Macmillan Press Ltd., Little Essex Street, London, WC2R 3LF, England. Price: £15 (Hard cover: 144 p.p.)