

GOLD FINANCING

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As we are the last speakers at the end of a two day conference we shall try to keep our comments as brief as possible. Our role is to outline why we see a future for gold bonds in Australia, as opposed to gold loans. There are two reasons for the attractiveness of gold bonds.

The first one is that banks, the providers of gold loans, generally do not like taking gold price risk. With a gold bond, however, producers would be borrowing from parties (investors) who want an exposure to gold. To understand this, you need to understand how gold loans work.

The basic concept is simple. A bank, which itself has borrowed gold, lends gold to a producer who in turn repays the bank in gold (or the cash equivalent). Provided the producer can produce gold (or has the funds to buy it) the system works. Problems only begin if the producer is unable to produce gold, particularly if the gold price has risen.

Typically, a bullion bank will lend gold to a producer. The problem for the bullion bank is that if the price of gold increases and the producer is unable to produce gold the bullion bank still has to repay its depositors (lenders). If the producer is unable to repay gold (or the cash equivalent), the bullion bank will have to buy gold on the open market at current prices. Bullion banks are reluctant to take on substantial risk because they have relatively small capital bases and, generally, don't understand project risks.

So what they do, and what Mace-Westpac did with the Paddington Gold Mine, is obtain a letter of credit from a trading bank. Trading banks better understand project risks and are better placed to take gold price risk. Thus, it is the trading bank and not the bullion bank that takes the credit exposure.

But even trading banks have a problem. If the price of gold increases and the producer is unable to produce gold, the trading bank is in a similar situation as the bullion bank would have been. Trading banks cover themselves to a large extent by introducing variation margins. That is, if the price of gold increases, say it doubles, the trading bank may require the

producer to lodge security (cash, gold, letter of credit etc) to cover any further increase in exposure.

From the producer's viewpoint this creates a potential problem as the producer may not be able to raise the additional security when it is required by the bank. Of course, if the price of gold increases, the value of the mine should also increase, and the producer should have little difficulty in raising the additional security. Nevertheless, from the producer's viewpoint, there is still an element of uncertainty.

To summarise our first point, we see an inherent weakness in the way gold loans are structured at present, in that banks are being asked to take gold price risk which basically they don't like doing. Therefore, wouldn't it be a better idea to borrow gold from parties who want an exposure to gold, namely, the investing public?

The second reason we believe gold bonds are more attractive than gold loans is that they are more tax effective.

If a producer borrows gold at 4% and has to repay gold, the cost of the loan is not just 4%. There is also an opportunity cost - if the price of gold increases, the producer will not receive the benefit of that increase in relation to production committed to service debt. In this sense, there is an opportunity cost. In our view, the opportunity cost should also be included in the cost of the loan. Conversely, if the price of gold falls, there is a benefit to the borrower, which should be deducted from the interest cost.

There is a general perception that investors regard gold as a reasonably good hedge against inflation. Put another way, investors perceive that the price of gold will rise in line with inflation.

Inflation, of course, is a basic component of interest rates. If interest rates are around 14% and inflation is running at 10%, the real interest rate is about 4%.

Thus, we can say that if the interest rate on a gold loan is 4% our best guess on the total cost of the loan is around 14% (4% plus inflation of 10%).

In most instances, it is possible to structure a gold loan such that the interest cost of 4% qualifies as a tax deduction. Unfortunately, it is not possible to obtain a deduction for the opportunity cost element of the total cost. That is, there is no deduction for any increase in principal repayments. In the above example, the after-tax cost of the loan is 12.16%.

Clearly, if it is possible to switch the mix of 4% and 10% to, say, 9% for interest and 5% for inflation, then the after-tax cost of the loan would be lower - 9.86%.

A gold bond provides a means of achieving this. It is achieved by issuing the bond at a premium over the current price of gold.

Suppose the current price of gold is \$400 per ounce and a producer issues a bond with a face value of \$5,000. In addition, the producer guarantees to redeem the bond after 5 years at either its face value of \$5,000 or the equivalent of 10 ounces of gold, whichever has the greater value. The coupon rate is 9%.

In this example, the producer is effectively selling part of its production now at \$500 per ounce - 25% above the current price of \$400. From the investor's viewpoint, the price of gold has to increase at 5% per annum for the next 5 years (ignoring the effects of compounding) before he receives more than \$5,000. The investor, of course, expects the price of gold to increase at 10% per annum (in line with inflation) giving a total return of 14% (9% interest and 5% net inflation).

There hasn't been a gold bond issue in Australia yet, but, because of their attractions, we believe the first issue is not far away.