GOLD FINANCING

Questions and Answers

Comment - Henderson Tuten:

I wonder about whether there is a gold bond market in Australia. I think it is very hard to distribute any type of investment (I admit that Australia is a punting market) but I don't know if I were given for instance the Paddington gold project that Warren Magi did for $25,000,000 or $30,000,000 of gold bonds, and I was told to distribute them, I don't know if I could do it in the Australian market, whereas drawing down gold loans, as Warren and I were talking earlier, you could literally do tons of gold if you knew the large part.

Comment - Warren Magi:

I guess I have a comment on that. I would have thought the essential ingredient which Warren Chant or Graham Cunningham spoke of in the course of that transaction, is that you really need someone in the transaction who is dealing with a gold miner, unless you are dealing with a very big company, you can assess the project risk, but it may be that the public are not really prepared to go into the metallurgical problems that a bank might.

The second is, the cost of the exercise. Gold loans, because of the simplicity of concept, basically are simple documents, you can make them longer if you repay it by inserting a lot of project covenants and securities, but the cost is relatively small, and as they become more and more standard, gets smaller. Whereas in going to the public, there are a large number of other costs, you have to prepare a prospectus, you may need some form of trust deed, the concepts are novel, you may need more sets of rules for the underwriters and for the trustee and you would need to pay an underwriting fee.

I would just wonder, and I would like to hear the commercial people talk on it, that it would seem to me to be in the context of the Australian market, a very expensive exercise.

Comment - Graham Cunningham:

Well first of all, I think you are quite right, there are a lot of small producers, and we are really not talking about a gold bond for those small producers. But Paddington was certainly large enough, and some of the other mines were certainly large enough, to take the gold bond. As to whether there is a market there, we could argue about that all day. But it is fair to say that we have seen some trusts set up, gold, for people to invest in, I forget precisely what the terms are, but gold related trusts. There is a lot of interest in gold, there always has been, and we just think there is a latent interest there in gold bonds.

In a sense, when we were doing our work on gold bonds, they are very similar to a convertible note. The concept is no different in that. The investor is basically taking an interest rate that is lower than the rate that they could get if they just went out and invested their money in the money markets, but they have got an equity sweetener there, in that if they convert it, they can convert into gold effectively later on. So the concept is no different really to convertible notes.

So the market already has that concept. In terms of underwriting costs etc. and documentation (yes they are costs and at the end of the day you wouldn't go into this lightly) you would have to be fairly convinced that there is a market there. But there are precedents for gold bond issues and silver bond issues. I don't know that it would be that much different. I don't know that the costs would be that much different. But I think it comes down to whether you think there is a market out there, whether you think there are enough Australians to spend $25,000,000 for a gold bond issue. We think there are.

Question:

The terms of the discussion have been essentially that these arrangements are confined to gold producers. If gold were to be regarded as in the nature of currency, which it is regarded I think in some cases, is there any scope for the development of these sorts of loans to other borrowers?

Answer - Henderson Tuten:

We have had a lot of approaches from, for instance, some large family companies here in Melbourne, who say why should I borrow at 6%, if I can do it at 2%, and we like gold anyway, and we like the Rothschilds. So bringing all that together, why can't we borrow gold to finance our building of a project.

I think we have seen what has happened to some of the borrowers here of US dollars, from Alan Bond to Rupert Murdoch, to the local importer. If you do it on gold, and President Reagan was shot tomorrow, you would have some real problems, and I think that the net worth of some of those companies would disappear rather quickly. So I guess the bottom line is, although that Australian dollar chart that I gave had a reasonably flat curve, there is no reason to suggest that gold couldn't do something very radical given some major change, and I think that volatility makes it for a local retailer or whoever, to borrow gold, a little bit like putting a gun to your head. And we have tried to argue against it as vehemently as we can.

Comment - Graham Cunningham:

I would like to make just one further comment. I don't know that it has come out of the discussion yet, and that is that we think that gold financing is a very conservative way of lending. You may remember when the foreign exchange, or when the hedge market came out, a lot of people used to say, I don't want to do that because it is too risky, I don't want to take a punt on what is happening to exchange rates. In fact, people now generally believe forward cover of foreign exchange is a very conservative way to cover yourself. And really I think loans are much the same.

I wrote an article some time last year, and I used an example of the coal industry. You may recall in the late 1970s and the early 1980s people were very gauche about what was going to happen about the price of coal. There was a lot of mine development and companies generally geared up much higher than they normally had, and in fact when they were borrowing for those projects, most of it was floating rate borrowing, and they were probably borrowing at around 10%. In 1983 and 1984 prices in fact went backwards and interest rates of course went up.

And the analogy is, I'm sure the coal producers would have liked it if their debt repayments had of been in coal, rather than in dollars. The revenues of the coal companies were coming down, but the debt obligations as a percentage of those revenues were going up. They were in trouble. But if they had had to make their repayments in coal rather than dollars, then their debt service repayments as a percentage of their revenue, would have correspondingly come down. So that is why we say fundamentally gold financing is all about being very very conservative, it is covering that downside, it is really not about covering upside, it is covering that downside.

We also believe that when you look at gold loans, you have to be cognisant of the fact that it is not just the interest cost that people try and sell you. It is not just that 4% or that 2%, that very low mark. If the price of gold goes up and you miss out on that increase in the price of gold for some part of your production, there is a cost there. So the real cost in gold financing is the interest rate, plus, if the price of gold goes up, what you miss out on. I just wanted to make that point a little clearer.

I must admit that makes a coal loan sound very attractive albeit that it may make the borrower very sooty. There was in fact one done in the Philippines in 1980.

Comment - Warren Magi:

I would just like to make a couple of points on those items. Theoretically it is possible to do a commodity financing of any commodity where there is stock available. It is the stock that is the key. In gold, that occurs naturally, because central banks hold something like 50% of total available gold stock in the world. Similarly in silver, there are large possessions accumulated or were accumulated as a result of the 79-80 run up.

Theoretically then, it is feasible to do something in oil, perhaps in copper and other commodities, where there are central locations, where a warehousing or borrowing facility can be set up.

I think it is also worth making the point that gold lending in Australia has introduced a new dimension to financing, as far as mining companies were concerned. Prior to the commencement of this type of financing, only quite recently, 4 months to 18 months ago, a small mining company, and typically it relates to gold because the project cost is under $20,000,000, a small mining company wishing to finance that $20,000,000 mine, would have had to go to the equity market. There was no choice at all. By and large banks weren't really interested, it was too small, there were much larger competing projects, and merchant banks just saw the risk as being too high.

So the introduction of leveraged financing into smallish companies, and some of these companies may well be developing mines with a capital cost of say $10,000,000 - $15,000,000 when their own capitalization is less than $10,000,000, is made up partly of the banking community's ability to make a more sophisticated decision about project financing, and the idea that by financing these projects with a gold loan, it provides a natural hedge and supports the project.

Your cash flow in the early days is much lower, you are only talking about 4% outgoings rather than 14%, and the natural hedge can assist in the economics of the computer models. It has not only been a new form of financing, but really opened up a new area of development so far as Australian mining is concerned.