GOLD FINANCING

HENDERSON TUTEN

Rothschild Australia Limited

The House of Rothschild has been lending gold bullion to clients in some form or another since the early 1800s. In those days, Mayer Amschel Rothschild used to lend people gold coins, and when they repaid him he would cut off the corner of the coin to represent his interest. I assume he had a little box somewhere, where he saved up all of those shavings and at the appropriate time, melted them down and created a new coin.

That form of lending, barter type lending, is basically what we are talking about today, and, in many ways it is no more complex than it was then. Today NM Rothschild and Sons Limited is the chairman of the London Gold Fixing which takes place at Rothschild's offices. Twice a day this group fixes the price of gold in the London market, and then that price is keyed on as the market gold prices are made throughout the world.

Where does Rothschild get their gold bullion to lend to people? I guess the gold borrower never understands why (1) you can lend gold at 3%, and (2) where did they get it in the first place. Very simply, London is a long gold market. People send their gold to London and it is kept on deposit with banking institutions. Central governments, companies and wealthy individuals in countries where for various reasons they might not want to keep their gold send it to London for safekeeping. So we have a lot of gold sitting in a vault, collecting some dust, and some bright person years ago said "let's put it to some sort of advantage".

Looking around the world, Australia has to be a capital poor country, and part of the reason for this is that new gold companies need to spend a little money before they are going to become gold producers. So we, in effect, export the gold, by lending our long position in London, to places like Australia, and then it is repaid as the new gold producer comes good.

So now we have Rothschild in Australia saying "now that we have got this gold to lend we are going to try to convince you, as the producer, to borrow that gold and then hopefully pay it back over time". The advantage for us as a lender, is that to lend gold is better than to have it sit around our vaults; we earn a spread, if we charge you 3% - hopefully our costs may be a little bit less than that.

There is another advantage as you repay that gold, and as you draw it down, it generates a transaction. Let us say that you draw down a gold loan here in Australia, and we physically sell that gold in London. This sale generates US dollars, which in turn generates a foreign exchange transaction for us here in Australia, as we change those US dollars into Australian dollars, and give them to you so you can go out and purchase your plant or whatever.

That then gives the lender two major advantages, both an interest return and the physical transaction. That is why most gold lenders require that the gold borrower not only repay his gold loan but also give the lender the physical transaction.

I have already mentioned that for the borrower there is an interest rate advantage. Let us say you were a watchmaker here in Australia, and for some reason you could export them to Switzerland and sell them for Swiss francs. You would want to borrow Swiss francs, because your revenue stream was in Swiss francs. You are matching your Swiss franc borrowing with your Swiss franc revenue. The borrowing costs of the Swiss franc may be 5%, and you then also have removed your currency risk.

In the same way as a producer you can borrow gold, as long as you can deliver the gold out of the ground (your export) and you are matching your revenue (the gold coming out of the ground) with your costs (the gold loan). So as long as you deliver the gold, you are matching and avoiding the risk, much the same as the Swiss exporter.

The second advantage, then, is the natural hedge. The other major advantage is that borrowing gold is simple. If you listen to a lot of people you would think borrowing gold is complex, but again in our shop at least, you get a bank overdraft, just the same as if you went to Westpac and your bank manager gave you a $50,000 overdraft. We would give you a 5,000 ounce overdraft, once a month that account would be debited for your interest costs, and then, as you got the ounces in, you would repay it. Of course just like your bank manager, I would be checking your limits to make sure you were staying within the original credit guidelines.

Now that I have explained all the benefits you are ready to do business with me for all those good reasons! The reality of the situation is that until recently it was very hard to get producers to borrow gold. That goes back to the fact that most gold producers are inherent gold bugs, they believe that the price of gold will never go down and it will always go up, over a time.

That faith has been somewhat distorted. From May of 1984 up until now the US dollar gold price has fallen from a high of over US$400 to around US$291. So if my producer had been able to see into the future, he would have drawn down a gold loan from Rothschild Australia at US$400, and then at this point in time he would now owe me the same ounces only having to convert them, if he did have to convert them, at US$290. He would have had a negative interest rate of 40% or 50% over that time.

Two years ago we would call the producer and he would pay us little attention. Now he calls us and says "oh by the way, remember two years ago when you visited us, we would like that loan in the next two days if possible."

The other important thing to consider from this perspective is that the $A price of gold has not deteriorated, and, in fact, it has stayed reasonably close to A$400. That is because the $A has devalued just as quickly as the gold price in $US has. That is not much solace for most of my clients, but for the gold clients it has definitely been a great cushion as that US dollar price has fallen.

The major pitfall for the producer is that if the price goes up after he has borrowed the money from me, there is an opportunity cost, and he is repaying me in more expensive gold than he originally borrowed. There are ways in which you can get around it, delay it, delay the gold loan, sell the gold, supply it, but essentially that is the major pitfall for him.

The major pitfall for me is the ability to deliver. If that fellow has a project that we have misread, if we have done our sums incorrectly, where the metallurgy is wrong, where the project is wrong or there are some sort of environmental problems, we are in trouble, especially if the gold price rises, because he can't deliver me the gold and therefore I have got a bad loan on my books. So, the key for us is to make those project assessments and make sure that the gold producer can deliver.

The major producers such as WMC are not borrowing gold. They have other methods available to them and they don't borrow that much in any form. The major users of gold loans are the middle sized producers, and that brings up the question of management. For years some so-called producers got away with just having exploration permits and never having to do any mining, they could just sit back and relax and go to the market and have another share issue.

The market is a little bit smarter now and says "wait a minute friends, you have got to actually have some production before we are going to buy your shares". So they had to actually walk out, look at their leases, and do some work. That is why I think that in those companies, management is the key. You obviously want to be very careful with them, can they actually get back to delivering. The key premium is to have operational management that knows what they are doing, and knows the pitfalls on the operational side of their balance sheet.

So in summary, in doing a gold loan, the producer gives up some of his blue sky, you give some of the tremendous upside potential. And that is important to gold companies, because people investing in gold companies are expecting that if they see the price of gold rise, then their share price will rise, and if this fellow has hedged or borrowed gold all the way out, they may not get the full advantage of that rise in the gold price.

However, in turn, for giving up that blue sky, you also give up the sleepless nights, you give up the fact that you might have to close down your plant and put it on care and maintenance, and you make your banker a lot happier, in the knowledge that most of your production is hedged.