GOLD LOANS

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Introduction

A gold loan is where the lender provides the borrower with gold which is either held as stock or sold to realise cash. Precious metal fabricators, refiners and jewellery manufacturers have for some time used gold loans to finance stock requirements. More recently gold mining companies have used gold loans to finance new mine development.

Gold loan financing for stock requirements

Where a fabricator, refiner or jeweller has a large stock of gold which is used in a manufacturing process he has two choices in the financing of that stock. He may borrow the cash to buy gold and then hedge it or alternatively he may simply choose to borrow the gold. The fabricator may of course simply borrow funds to buy gold and not hedge, however this would involve him in considerable risk if the price of gold were to fall. Precious metal fabricators normally hold their stocks on a fully hedged basis and we will examine both financing techniques on the basis that the borrower seeks to be fully hedged.

Funding the purchase of gold and then hedging stocks

Let us assume a gold fabricator purchases 10,000 oz of gold at A$400 per oz. The total value of the purchase is then A$4,000,000. In order to finance this purchase he borrows money which carries an interest charge of 14.0% pa. At the same time the fabricator hedges his stock by selling it in either the futures market or the forward market. The contango or interest premium for the forward date is say 10.0% pa (meaning that if he sold three months forward the price would be A$410 per ounce). As a result the net financing cost to the fabricator is 4.0% pa made up of the cost of borrowings less the return earned from hedging.

Under this approach the fabricator does not have any exposure to variations in the gold price. If the price of gold were to fall to A$300 per oz his gold would have a value of A$3,000,000. However he would have a profit on his hedge position of A$1,000,000 so the overall value of his gold stock and hedge position is constant at A$4,000,000. In the same way if the gold price rose to A$500 per oz the gold stock would increase in value to A$5,000,000. However he would have a loss on his gold hedge of A$1,000,000 and the 10,000 oz of gold, taken together with the hedge would still be worth A$4,000,000.

Borrowing gold to provide stock requirements

Under a gold loan the fabricator would borrow 10,000 oz of gold and pay a gold borrowing fee of say 4.0% pa on the value of the gold. The result for the borrower is very similar to that of a purchase and hedging arrangement except that he does not have to raise cash and hedge stock but rather, by borrowing gold effects both of these transactions at once.

As it is the fabricator's intention to hold the 10,000 oz of gold in stock at all times he is not concerned by price movements. If the gold price increases, the dollar value of the gold loan is higher but so is the value of the borrower's stock. Similarly if the gold price falls the dollar value of the gold loan and gold stock declines. In a balance sheet context the borrower's liability to the lender is always matched by his current asset in stock.

Gold loan finance for gold mining projects

A gold loan used to finance a new gold mine provides cash which contrasts with the gold loan to a fabricator where the loan avoided the need for the fabricator to raise cash.

A typical financing for a gold.mine might involve a A$16 million gold loan by way of project finance. The mine construction lead time could be one year and production expected to be 40,000 oz of gold per annum for ten years.

In this case the intending producer would borrow 40,000 oz of gold which he would sell at the prevailing spot price of say A$400 per oz yielding A$16,000,000. Repayment would then be 10,000 oz of gold per annum in years 2, 3, 4 and 5 being the first, second, third and fourth years of production. Gold loan repayments would represent 25% of production over the repayment period. This gold loan would be fairly typical of those made in Australia to finance small to medium mines. The term of the gold loan is five years with which progressive repayments representing 25% of production over the period.

The gold producer could in theory have borrowed cash to finance the mine and then sold future gold production forward as an offsetting hedge. In practice, it is difficult for a gold producer to be able to make forward sales through the futures markets or forward markets for terms in excess of one year. In addition, a forward sale of production could result in adverse cash flows to the producer in the event that the gold price rose and he was required to make margin payments on his sold position. However, probably most importantly the gold producer may find that he is more readily able to raise appropriate finance by way of a gold loan. By making the finance available in this form the lender builds a hedge into the loan. Furthermore this hedge is entirely under the control of the lender. The natural hedge to a lender of a gold loan is contained in the fact that if the price of gold falls and the viability of a project declines the dollar exposure of the lender also declines as the loan is denominated in a fixed number of ounces of gold lent. In the converse way if the gold price rises the increased dollar exposure of the lender under a gold loan is offset by the improved economics of the project.

Operating procedures for gold loans

Borrower

The borrower can accept a gold loan either as physical bars of gold or as a credit to his gold account. Fabricators will normally take loans in the form of physical gold whereas producers who are seeking cash proceeds, will normally take a gold loan by way of a credit balance to their gold account. Where the gold loan is made by way of crediting the borrower's gold account the borrower is then free to sell gold up to the amount of the credit balance in his gold account. As the crediting of a gold account does not involve storage, insurance and shipping charges it is simpler and cheaper than taking delivery of physical gold.

One feature of the drawdown of a gold loan used in the financing of a gold mining development is the use of forward selling. After documentation of a gold loan is completed the producer could sell all the gold available on a spot basis thus raising the cash required. However, as payments for mine construction are normally progressive, this will mean that the funds will be lodged in the money market and withdrawn as required. While this is satisfactory from a cashflow point of view it has the effect of generating assessable income in the hands of the producer. An alternative approach by the producer is to draw down only part of the gold on a spot basis and to draw the balance as forward sales. In this way the forward sales are made to mature at times of cash payments under the mine construction programme and the contango or interest premium on the forward accrues as gold sale revenue which is exempt income in the hands of a gold producer.

Lender

The provision of gold loans requires a lender to have access to substantial stocks of gold. Typically gold loans are effected by bullion dealers who have access to or are holding large stocks of gold at all times. A bullion dealer will hold his own stocks of gold, stocks of gold on behalf of customers, be able to borrow gold in the inter-dealer market and have access to central bank gold stocks.

In this way a gold loan for a bullion dealer is much the same as a cash loan for a bank or merchant bank. The bank or merchant bank will raise cash to finance a loan and will charge the customer a margin over his cost of funds. Similarly a bullion dealer will borrow gold in the market and charge the customer a fee which comprises the dealers gold borrowing cost plus a margin. The fee on a gold loan is expressed as a percentage per annum based on the market value of gold calculated either daily, quarterly or as agreed.

It should be noted then, that the bullion dealer is not involved in any price risk on a gold loan as he borrows the same number of ounces as he lends.

Although there is no price risk to a lender under a gold loan, the dollar value of the loan varies in accordance with movements in the price of gold. Accordingly a gold loan made for 10,000 oz of gold when the price is A$400 per oz represents a credit exposure of A$4,000,000. If the price of gold were to rise the credit exposure of the lender also rises. In order to put a limit on the lender's credit exposure most gold loans also have a ceiling on total value. In the above example of a gold loan of 10,000 oz made when the price of gold was A$400 per oz it may be a condition of the loan that should the price of gold exceed A$600 per oz then the producer would be required to lodge gold or cash as security with the lender such that the total dollar value of the loan never exceeded A$6,000,000. These dollar ceilings or margin variation limits are set to allow significant movements in the price of gold before they become operative and are designed as a part of the review of a loan by the lender. With a rising gold price the economies of a mine will naturally improve and the lender may waive his requirement for margin payment if he is happy with the progress of the development of the mine.

The issue of total dollar ceilings on gold loans and the requirement for margin payments highlights the fact that a lender approaches the assessment of credit risk under a gold loan in exactly the same way as he would under a cash loan. However, as a gold loan provides a partial hedge for a lender and reduces the cashflow requirements of the producer in the early stages of development, it may well be that the economics of a mine or the viability of the financing for the mine is enhanced by the application of the gold loan technique.

Conclusion

While gold loans have existed in various forms for many years their application to mine development financing has been more recent. A number of gold loan financings for new gold mine developments have been put in place in Australia over the past year. These financings have attracted international interest and are particularly suitable to the Australian environment where gold resources are being developed by small to medium sized companies who are for the most part not existing gold producers.